Small Business Tax Benefits: Current Law and Main Arguments For and Against Them

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Summary

The federal tax burden on small firms and its effects on their formation and growth have long been issues of legislative concern for Congress. This interest helped pave the way for the enactment during the 111th and 112th Congresses of several laws intended, in part, to reduce this burden or keep it in check. The American Recovery and Reinvestment Act of 2009 (P.L. 111-5), the Small Business Jobs Act of 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-240), and the American Taxpayer Relief Act of 2012 (P.L. 112-240) each contained provisions offering tax benefits to small companies.

This report describes the main federal tax preferences that benefit small firms and examines the main arguments for and against them. It addresses tax preferences that can be claimed by qualified small firms in a wide range of industries and excludes those targeted at small firms in specific industries, such as the special deduction for small life insurance companies under Section 806 of the federal tax code. The following small business tax benefits have a broad reach outside agriculture and are among the tax preferences examined here:

- the taxation of small firms as passthrough entities;
- the graduated rate structure for the corporate income tax;
- the expensing allowance for machinery and equipment under Section 179 of the Internal Revenue Code;
- the exemption of some small corporations from the corporate alternative minimum tax;
- cash-basis accounting;
- a tax credit for a portion of the costs incurred by small firms in establishing pension funds for employees;
- a tax credit for costs incurred by small firms in complying with the Americans with Disabilities Act;
- the partial exclusion from the capital gains tax on the sale or exchange of qualified small business stock; and
- a tax credit for small firms that offer qualified health insurance coverage to employees.

While available information does not allow for an estimate of the federal revenue cost of all the small business tax preferences examined here, estimates by the Joint Committee on Taxation and the Treasury Department's Office of Tax Analysis suggest that it may exceed $11 billion in FY2013.

Tax preferences for small businesses raise several policy issues. For some, a key question is whether or not they can be justified on economic grounds. In the absence of such a justification, small business tax benefits may create more economic harm than good.

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Introduction

Lawmakers have long held small business owners in high regard. This admiration stems mostly from the contributions small business owners make to the economy and their communities. The federal tax burden on small firms and its effects on their formation, performance, and growth are issues of continuing concern for Congress.

Most lawmakers regard small firms as a vital and invaluable source of job creation and technological innovation, as well as an effective vehicle for advancing the social and economic status of minorities, immigrants, and women. Many lawmakers have also come to see current federal tax laws as both an obstacle to small business formation and growth and a policy tool for boosting their rates of formation and growth. Recent Congresses passed a variety of measures that included tax preferences for small firms. In the 111th Congress, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5), the Small Business Jobs Act of 2010 (P.L. 111-240), and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) all contained provisions creating new small business tax benefits or enhancing or extending existing ones. Though passing fewer bills with business tax provisions, the 112th Congress concluded with the passage of a bill extending and enhancing several tax preferences offering varied benefits to small companies: the American Taxpayer Relief Act of 2012 (P.L. 112-240).

Small business tax benefits and proposals to enhance them or establish new ones raise various policy issues. One issue is how to define a small business for the purpose of formulating and implementing public policies. Resolving it requires grappling with several vexing matters, such as selecting the appropriate size measure (e.g., employment, assets, or receipts) and deciding whether the same small firms should qualify for tax benefits and other forms of federal assistance aimed at promoting their formation and growth.

For economists, a central issue is whether the benefits can be justified on economic grounds. If it turns out that such a rationale cannot be found, small business tax benefits may do more harm than good by distorting the process of domestic resource allocation.

Yet another policy issue concerns the most cost-effective ways to assist small firms. Small business tax subsidies involve costs in the form of revenue losses, the cost to companies of complying with the rules governing the use of the subsidies, the cost to the federal government of administering those requirements, any interest charges related to the revenue losses, and the opportunity cost of using these resources for the promotion of small businesses. These costs have led some to question whether current small business tax benefits are a better use of federal funds than alternative policy options for supporting small firms such as grants, loan guarantees, and exemptions from certain federal regulations.

This report explores these issues by identifying the main non-agricultural small business tax preferences and examining the economic arguments that could be made for or against them. It begins by exploring the challenges of coming up with a widely accepted definition of a small business for policy purposes, continues with a brief description of existing preferences for small firms, reviews what is known about the economic contributions of small firms in general, and concludes with a discussion of those arguments. The report will be updated to reflect recent

legislative action and other developments having a significant impact on the tax benefits examined here.

Eligibility Criteria: How Small Is Small?

Size Standards and the Small Business Act of 1953

In analyzing the impact of public policy on small firms, a necessary starting point is the definition of a small firm. When it comes to understanding how a small firm is defined for the purpose of eligibility for federal programs to support small businesses, an essential point of departure is the Small Business Act of 1953 (P.L. 83-163, as amended).

The act granted the Administrator of the Small Business Administration (SBA) the authority to establish small business size standards for federal programs. A size standard specifies the maximum size a company can be (whatever the measure) and still qualify for assistance. The act also gave the Administrator broad discretion in determining what those standards should be and how they should be established. Since its passage, Congress has refrained from creating size standards for specific federal programs, except for agricultural enterprises. Other federal agencies may create small business size standards for programs they administer, but they cannot be used without the approval of the Administrator.[1]

While empowering the SBA to select the size standards that are used to determine eligibility for federal programs, the act also set forth two fundamental criteria for identifying eligible small businesses. Paragraph 3(a)(1) stated that "for the purposes of this Act, a small business concern.... shall be deemed to be one which is independently owned and operated and which is not dominant in its field of operation."[2]

According to the SBA, the act and its legislative history made it clear that two considerations should guide the agency in establishing size standards for all industries. First, the standards should vary to reflect differences among industries. Second, the federal programs subject to the standards, including those administered by the SBA, should enable affected small firms to improve their competitiveness within the domestic economy.

In the case of the industry-based size standards, the SBA has been using three specific criteria to identify eligible firms since the early 1950s: (1) average number of employees in the past year, (2) average annual receipts in the previous three years, and (3) value of assets. But employment and receipt size are used to determine eligibility among the vast majority of industries listed in the North American Industrial Classification System (NAICS). The choice depends on an industry's key structural features.

SBA has established three "base" or "anchor" size standards that play a central role in the agency's ongoing review of the standard it has set for every NAICS industry. For manufacturing, mining, and other industries with an employee-based standard, the base standard is 500

[1] For more information on the historical development of SBA size standards, see CRS Report R40860, *Small Business Size Standards: A Historical Analysis of Contemporary Issues*, by (name redacted).

[2] 15 U.S.C. §632(a)(1)

employees. For industries with a receipts-based standard, including most non-manufacturing industries, the base standard is $7.0 million in average annual receipts. And the base standard is 100 employees for firms involved in wholesale trade. For a limited number of industries, the SBA uses other measures of size that are appropriate for the nature of their main lines of business. For example, financial assets are used for banking, barrels per calendar-day for petroleum refining, and the share of overall power generation for electric utilities.

In setting or revising a size standard for an industry, the SBA uses the relevant anchor standard as the starting point. Whether a size standard is set below, at, or above that level depends on the results of an evaluation of certain industry characteristics, especially the average firm size, start-up costs, entry barriers, the degree of competition among firms, and the distribution of firms by size. The SBA also takes into consideration the impact of a current or proposed size standard on the access of an industry's small firms to federal procurement contracts.

According to the SBA's current table of small business size standards, standards based on receipt size range from $0.75 million to $35.5 million; those based on employment range from 100 to 1,500 employees; those based on financial assets are set at either $7 million or $175 million; those based on power generation are uniformly set at 4 million megawatt hours; and those based on petroleum refining are set at 1,500 employees and 125,000 barrels per calendar day.[3]

The SBA can and does alter the size standard for particular industries. Before a proposed change can take effect, however, the agency's Office of Size Standards (OSS) is required to assess the likely impact of the change on the performance of the affected industry (or industries), concentrating on the degree of competition, average firm size, start-up costs, barriers to entry, and distribution of sales and employment by firm size. OSS then uses the results to make recommendations to SBA's Size Policy Board. If the Board agrees with the recommendations, it typically advises the Administrator to approve the proposed change. Approved changes must be published in the *Federal Register* for public comment. The SBA then considers the comments received from the public, as well as any other new information, before issuing a final rule. (Details on current SBA efforts to revise industry size standards can be found through the agency's website.[4])

As a result of the Small Business Jobs Act of 2010 (P.L. 111-240), the SBA also has the authority to establish alternative size standards based on tangible net worth and average after-tax profits for the 7(a) and the 504/CDC loan programs it administers. No such standard had been issued as of early March 2013. Until the SBA does so, the act sets the tangible net worth limit at $15 million and the average after-tax profit limit at $5 million, excluding any net operating losses carried over from previous tax years, in the two fiscal years before the date of a company's loan application.

The act also required the SBA to review at least one-third of NAICS industry size standards every 18 months and to make "appropriate adjustments" to reflect current market conditions. No later than 30 days after a review is completed, the SBA must file a report on its findings to the House Committee on Small Business and the Senate Committee on Small Business and Entrepreneurship. It is also required to publicize its reasons for modifying or retaining each reviewed size standard.

[3] See http://www.sba.gov/sites/default/files/files/Size_Standards_Table(1).pdf.

[4] See http://www.sba.gov/content/whats-new-with-size-standards.

Federal agencies administering programs that reserve a share of procurement contracts for small firms (small business set-aside programs) are required to use the SBA size standards. Other federal programs or tax provisions supporting small businesses may use those standards, though they are not required to do so. Agencies are free to develop their own size standards, but they must survive a rigorous rulemaking process overseen by the SBA before the new standards can be applied. An agency must get the approval of the SBA Administrator before it may use a new standard.

In a 2009 document explaining its methodology for selecting size standards, the SBA discussed the key policy issues raised by its program to establish and revise those standards. It regarded many of them as settled but noted that the others continue to stir up debate among interested lawmakers and analysts.[5] Among the unresolved issues are the following:

- Should there be a fixed range for a size standard (e.g., 100 to 1,500 employees)?
- Should the standards be adjusted for inflation more often than once every five years?
- Should the employment standard be adjusted for productivity gains in an industry?
- Should the SBA lower its size standards for federal contracts in response to recommendations from the private sector?
- Should the size standards be calculated in dollars and cents to reflect actual differences among industries in their key structural features?

Definition of Small Business in the Federal Tax Code

Does the federal tax code use the SBA size standards to determine eligibility for small business tax benefits? Yes, for the most part.

As **Table 1** shows**,** most preferences rely on asset, receipt, or employment size to identify eligible firms.[6] Some of the size standards in the tax code use employment or receipts, like the SBA size standards for most industries. But the employment and receipt sizes found in the tax code are much smaller than the sizes used by the SBA. In addition, a few tax provisions bestow their benefits on small firms not through a size standard but as a consequence of their design. A case in point is the expensing allowance under Section 179 of the Internal Revenue Code (IRC). Although the statutory language of the provision makes it clear that firms of all sizes may claim the allowance, its design effectively limits its benefits to relatively small firms (more on this later).

There is no explicit rationale in the tax code for employing different size standards in determining eligibility for small business tax benefits. The lack of a uniform definition has at least one advantage and one disadvantage. On the one hand, the different size standards can lead to an

[5] See Small Business Administration, Size Standards Division and Office of Contracting & Business Development, *SBA Size Standards Methodology* (Washington: April 2009), pp. 45-48.

[6] According to one source, 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*, August 2003, pp. 4-6.

uneven and arbitrary distribution of tax benefits among companies that are similar in line of business and employment, receipt, or asset size. For instance, two small companies with the same number of employees may not be eligible for the same tax preferences because they differ significantly in asset and receipt size. On the other hand, the absence of a uniform definition may give lawmakers greater latitude in designing tax benefits to support specific policy objectives related to small businesses. Possible examples include refundable tax credits for start-up companies investing in alternative energy production and a temporary exemption from the employer's share of the federal payroll tax for smaller firms that hire new workers.

Main Federal Tax Benefits for Small Business

In principle, all business income is subject to federal taxation. But the truth is that the federal tax code does not treat all business income equally.

The taxation of business income depends on several factors. One is whether or not a firm is organized for tax purposes as a C corporation or as a passthrough entity. Corporate profits are taxed twice: once at the firm level and a second time at the shareholder level when the profits are distributed as dividends or long-term capital gains. By contrast, the net income of passthrough entities such as S corporations, sole proprietorships, or partnerships is taxed only once: at the level of the owner or shareholder.

Furthermore, the taxation of business income depends on whether or not a C corporation or the owner of a passthrough entity pays the alternative minimum tax (AMT). Corporations or business owners paying the AMT may or may not be taxed at lower rates than they would be under the regular income tax.

Another consideration affecting the taxation of business income is the financing of investments. C corporations that borrow to finance investments may deduct interest payments to lenders from taxable income, but they are not allowed to deduct dividend payments to shareholders when investments are financed by sales of company stock. As a result, the returns to corporate investments financed solely by debt are taxed at lower marginal effective rates than the returns to investments financed solely by equity, all other things being equal.

Firm size is another key factor. Some tax provisions offer benefits to smaller firms that are not available, or are of lesser value, to larger firms. There is no formal distinction between the taxation of small and large firms in the tax code. Rather, small business tax benefits are scattered throughout the code. Most come in the form of deductions, exclusions, exemptions, credits, deferrals, and preferential tax rates whose main effects are to reduce the cost of capital and increase cash flow. Yet a few tax provisions benefit small firms in other ways.

The federal tax benefits targeted at smaller firms with the broadest reach outside agriculture are discussed below. Excluded from the list are subsidies available only to eligible small firms in particular industries, such as life insurance, banking, and energy production or distribution. Nor does the list include tax benefits that are available to firms of all sizes, such as the research and work opportunity tax credits. **Table 1** summarizes the key features of each of the tax benefits.

It is not known how much revenue is lost because of these tax benefits. Nevertheless, recent estimates by the Joint Committee on Taxation (JCT), the Congressional Budget Office, and the

Treasury Department suggest that their revenue cost may exceed $11 billion in FY2013 (see **Table 1**).[7]

Table 1. Current or Recent Small Business Tax Preferences and Their Revenue Cost in FY2013

Small Business Tax Preference	Federal Tax Code Section	Nature of the Benefit	Eligible Firms	Current Status	Revenue Cost in FY2013 Under Current Law ($ billions)
Limited Expensing Allowance	179	Allows firms to deduct as a current expense their expenditures on qualified depreciable assets, within certain limits	No size limit	Permanent	4.4
Graduated Corporate Tax Rates	11	Taxes the net income of small C corporations at lower rates than the net income of larger C corporations	C corporations with $10 million or less in taxable income	Permanent	3.1
Tax Credit for Employee Health Insurance Costs	45R	Allows eligible small employers to take a non-refundable tax credit for non-elective contributions that cover 50% or more of the cost of health plans for participating employees	Employers with 25 or fewer employees whose average annual compensation does not exceed $50,000	Permanent	1.8
Non-Agricultural Cash-Basis Accounting	446	Allows eligible small partnerships and C corporations to use the cash	C corporations and partnerships with average annual gross receipts of $5	Permanent	1.1

[7] In FY2013, the combined revenue loss for the small business tax preferences examined in the report for which estimates are available is $10.8 billion. It pertains to the following small business tax preferences: (1) expensing of depreciable business property; (2) reduced rates on the first $10 million of corporate taxable income; (3) a tax credit for eligible small employer health insurance expenses; (4) cash accounting outside agriculture; (5) the partial exclusion of capital gains on the sale of certain small business stock; (6) the ordinary income treatment of losses on the sale of small business corporation stock; and (7) the amortization of business start-up costs. See U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13 (Washington: GPO, 2013), table 1; and Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013* (Washington: U.S. Govt. Print. Off., 2013), table 17-1.

Small Business Tax Preference	Federal Tax Code Section	Nature of the Benefit	Eligible Firms	Current Status	Revenue Cost in FY2013 Under Current Law ($ billions)
		method of accounting	million or less in the previous three tax years		
Partial Exclusion for Gains from the Sale of Qualified Small Business Stock	1202	Allows non-corporate investors to exclude between 50% and 100% of any gains on the disposition of qualified small business stock held for five or more years	Stock must be issued by C corporations in a qualified business that have $50 million or less in gross assets when the stock is issued	Permanent	0.3
Deduction and Amortization of Eligible Business Start-Up Expenses	195	Allows start-up businesses to deduct up to $5,000 of eligible start-up expenses in the year they begin to operate, and to amortize the remaining expenses over 180 months; the deduction phases out, dollar for dollar, when total qualified expenses exceed $50,000	Firms in their first year of business	Permanent	0.1
Ordinary Income Treatment of Losses on Sales of Certain Small Business Stock	1244	Allows taxpayers to deduct any loss from the sale, exchange, or worthlessness of qualified small business stock as an ordinary loss and not a capital loss	Individuals and partnerships	Permanent	0.1
Rollover of Certain Gains into Specialized Small Business Investment Companies (SSBICs)	1044	Allows taxpayers to roll over, free of tax, any gains on the sale of publicly traded securities, if the gains are used to purchase common stock or a partnership	Individual and corporations	Permanent	Not Available (NA)

Small Business Tax Preference	Federal Tax Code Section	Nature of the Benefit	Eligible Firms	Current Status	Revenue Cost in FY2013 Under Current Law ($ billions)
		interest in licensed SSBICs			
Treating Losses on the Sale of Small Business Investment Company (SBIC) Stock as Ordinary Losses	1242	Allows individual taxpayers who invest in SBICs to deduct from ordinary income all losses from the sale or exchange or worthlessness of SBIC stock	Any individual investing in an operating SBIC	Permanent	NA
Exemption from the Uniform Capitalization Rule	263A	Exempts qualified small firms from the requirement that firms acquiring real or tangible property for resale capitalize or include in the estimated value of their inventory the direct cost of the property included in it, as well as the indirect costs that can be allocated to the property	Business taxpayers with average annual gross receipts of $10 million or less in the three previous tax years	Permanent	NA
Simplified Dollar-Value LIFO Accounting Method	474	Allows qualified small firms to use a simpler LIFO method in estimating the base-year value of their inventories	Business taxpayers with average annual gross receipts of $5 million or less in the three previous tax years	Permanent	NA
Tax Credit for Pension Plan Start-Up Expenses	45E	Allows qualified small firms to take a non-refundable tax credit for a portion of the costs they incur in establishing new qualified pension plans for employees	Employers with fewer than 100 employees, each of whom received $5,000 or more in compensation in the previous calendar year, and with one or more highly paid employee	Permanent	NA

Small Business Tax Preference	Federal Tax Code Section	Nature of the Benefit	Eligible Firms	Current Status	Revenue Cost in FY2013 Under Current Law ($ billions)
			participating in the plan		
Tax Credit for Expenses Incurred in Improving the Accessibility of a Business for Disabled Individuals	44	Allows qualified small firms to claim a non-refundable tax credit for qualified expenses they incur in making their facilities more accessible for disabled persons	Employers with gross receipts of $1 million or less in the previous tax year, or with 30 or fewer full-time employees during that year	Permanent	NA
Exemption of Small C Corporations from the Alternative Minimum Tax (AMT)	55(e)	Exempts qualified C corporations from the AMT	C corporations with average annual gross receipts of $5 million or less in their first three tax years and $7.5 million or less in each subsequent three-year period	Permanent	NA
Taxation of Passthrough Entities	1(h)	Subjects net income of passthrough entities to one level of taxation at the owner's individual tax rate	No size limit for passthrough entities	Current individual, capital gains, and dividend tax rates are due to expire at the end of 2012	NA

Source: Congressional Research Service; Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017,* JCS-1-13, and *Estimated Budget Effects of the Revenue Provisions Contained in Senate Amendment #4594 to H.R. 5297, the "Small Business Jobs Act of 2010,"* JCX-48-10; and Office of Management and Budget, *Analytical Perspectives: Fiscal Year 2013 Budget*, table 17-1.

Taxation of Passthrough Entities

Business enterprises operate in a variety of legal organizational forms. Each state determines the range of available options. Federal tax law recognizes five such forms: subchapter C corporations, subchapter S corporations, sole proprietorships, partnerships, and limited liability companies (LLCs).

A firm's legal form has a bearing on the taxation of its earnings. The earnings of C corporations are taxed twice: once at the corporate level and again at the individual level when the earnings are distributed to shareholders or owners as dividends or realized capital gains. By contrast, the

earnings of all other business entities are taxed only once: at the individual level of their owners or shareholders. As a result, these entities are referred to as passthrough entities: their earnings are not taxed at the entity level but are passed through to the owners, who pay taxes on them as part of their total personal taxable income.[8] The entities' profits, losses, items of income, deduction, exclusion, deferral, and credit are attributed to owners according to their shares of ownership, regardless of whether any profits have actually been distributed. Most non-farm businesses operate as sole proprietorships: from 2005 to 2008, they filed an annual average of 72% of federal non-farm business tax returns, followed by S corporations (12.5%), partnerships (9.5%), and C corporations (6%).[9]

There is no requirement under federal tax law that C corporations be relatively large in income, asset or employment size, or that passthrough firms be relatively small. Yet such a difference is the norm: from 2005 to 2008, C corporations accounted for 62% of total business receipts reported on federal tax returns, followed by S corporations (20%), partnerships (13%), and non-farm sole proprietorships (4.5%).[10]

Individuals starting a business need to determine in advance how the business will be organized for legal and tax purposes. Making such a decision involves a number of tax and non-tax considerations. The key non-tax considerations are the legal liability of shareholders, access to capital markets, and extent of shareholder control of management. Foremost among the tax considerations are relative tax rates for corporate income, individual ordinary income, and long-term capital gains; the investment horizon of investors; the expected holding period for corporate stock; and the rate at which corporate profits are paid out as dividends.

Whether someone starting a business today would be better off on the basis of tax considerations alone operating as a C corporation or as a passthrough entity depends on ordinary income tax rates, corporate tax rates, capital gains tax rates, and the investment horizon. A few simplified investment scenarios can illustrate this point.

Suppose that the pre-tax rate of return for a project is a constant R a year regardless of whether it is undertaken as a C corporation or a partnership; the project lasts for n years, after which the business is liquidated; all after-tax income generated in the interim is reinvested in the business; there is no capital gain or loss on the liquidation of the partnership interest; and the corporation pays taxes each year at rate t_c on its before-tax income. Under these assumptions, the after-tax return for an initial investment by a partnership is given by the following formula: $\$I\,[1 + R\,(1 - t_p)]^n$, where I is the amount of the initial investment, R the pre-tax rate of return, t_p the top individual income tax rate, and n the length of the investment horizon in years. And the after-tax return for an initial investment by a C corporation is given by the following formula: $\$I\,[1 + R\,(1 - t_c)]^n\,(1 - t_{cg}) + (\$I \times t_{cg})$, where t_{cg} is the top capital gains tax rate. Since the corporation is liquidated at the end of one year, all distributions to shareholders are taxed as capital gains.

In 2013, the top personal tax rate is 39.6% for taxable income above $400,000; most corporate profits are taxed at 35%; and the top tax rate on long-term capital gains is 20%.[11] If the pre-tax

[8] CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by (name re dacted).

[9] See *Table 3: Selected Integrated Business Data* at http://www.irs.ustreas.gov/taxstats/bustaxstats/article/0,,id=152029,00.html

[10] Ibid.

[11] The American Taxpayer Relief Act of 2012 (P.L. 112-240) increased the top individual rate to 39.6% and the top (continued...)

rate of return is 20% for a project whether it is carried out by a corporation or a partnership, *n* is one year, and the 2013 tax rates apply, then an individual subject to the top individual income and capital gains tax rates would he be better off for tax reasons alone operating a business organized as a C corporation rather than a partnership. Plugging these figures into the two formulas, the after-tax return to investing one dollar in a partnership would be $1.12, while it would be $1.10 for every dollar invested in a C corporation.[12]

If the investment horizon were extended to five years and all other variables remained the same, would this person want to make the same choice? Not necessarily. The truth is that she would have reason to be indifferent on the basis of tax considerations alone. This is because a business organized as a partnership would realize an after-tax return of $1.77 for each dollar invested five years earlier, while the after-tax return for a C corporation would be $1.67.

Now suppose the same individual is taxed at a marginal rate of 25% and subject to a long-term capital gains rate of 15% and the top corporate tax rate were 35%. Under these assumptions, she would receive an after-tax return of $1.15 for each dollar invested in a partnership for one year, compared to an after-tax return of $1.11 for a C corporation. Under a five-year investment horizon, she would earn an after-tax return of $2.01 for each dollar invested in a partnership five years earlier but only $1.72 for each dollar invested in a C corporation.

Clearly, she would be better off on tax grounds alone to operate as a partnership. This would still be the case even if the top corporate tax rate were lowered to 25% with no changes in current individual and capital gains tax rates, as some lawmakers and President Obama have advocated.

Nonetheless, it would be technically incorrect to view the taxation of passthrough entities as a small business tax benefit. This is because a firm's size has no bearing on its ability to operate as a passthrough entity or corporation. Some firms that are relatively large in employment, revenue, or assets are organized as S corporations or partnerships, while some firms that are relatively small by the same measures operate as C corporations. In 2009, the most recent year for which complete tax return data are available, 15.2% of S corporations and 7.7% of partnerships filing federal income tax returns reported business receipts above $1 million, while 78.4% of C corporations filing returns reported business receipts below $1 million.[13]

Some see the ability of small companies to avoid the corporate income tax as the single most valuable small business tax benefit.[14] But as the comparative analysis presented here shows, the validity of such a view hinges on relative individual and corporate tax rates. If the recent past is a reliable guide, the current tax advantage held by passthrough entities may prove short-lived. It would vanish if legislation were enacted that expanded the gap between the top individual rate and the maximum corporate tax rate and increased the top capital gains tax rate. The advantage would also disappear if the top corporate tax rate were lowered without reducing the top individual and capital gains tax rates. President Obama has called for a reduction in the top

(...continued)

capital gains rate to 20%.

[12] See Myron S. Scholes, et. al., *Taxes and Business Strategy: A Planning Approach*, 3rd edition (Upper Saddle River, NJ: Pearson Prentice-Hall, Inc., 2005), pp. 85-87.

[13] See http://www.irs.gov/uac/SOI-Tax-Stats-Historical-Table-12.

[14] See Alan D. Viard and Amy Roden, "Big Business: The Other Engine of Economic Growth," *Tax Policy Outlook*, American Enterprise Institute (Washington: June 2009), p. 2.

corporate tax rate to 28% as part of a package of reforms to the corporate income tax, and several bills introduced in the 112th Congress would have lowered the top rate to 25%.

Graduated Corporate Income Tax Rates

Corporations with less than $10 million in taxable income are subject to a set of graduated tax rates. The rate is 15% on the first $50,000 of income, 25% on the next $25,000, and 34% on amounts between $75,000 and $100,000 and between $335,000 and $10 million. Corporations with taxable incomes ranging from $10 million to $15 million pay a marginal rate of 35%. To offset the tax savings from the rates below 35%, corporations face marginal tax rates greater than 35% in two income ranges. A corporation with taxable income between $100,000 and $335,000 pays a marginal rate of 39%; if its taxable income falls between $15 million and $18.3 million, the firm pays a marginal rate of 38%. All corporate taxable income above $18.3 million is taxed at a rate of 35%.

This rate structure clearly benefits corporations that are relatively small in employment or asset size. It also gives owners of closely held small firms an incentive to incorporate in order to shield profits from higher individual tax rates. But not all small corporations are allowed to take advantage of the reduced rates. Regardless of the amount, 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%.

The graduated rate structure has one drawback that is shared by several other small business tax preferences: it gives small corporations a disincentive to grow to the point where their net incomes are taxed at the top rate of 35%. Some argue that this rate structure serves as a tax on growth.

Expensing Allowance for Certain Depreciable Business Assets

Expensing is the most accelerated form of depreciation for tax purposes. It entails treating the cost of acquiring a depreciable asset such as a machine tool or building as a current expense rather than a capital expense. Under such depreciation schedule, the full cost of the asset is deducted in the year when it is placed into service. Otherwise, companies recover capital costs for tax purposes over longer periods by applying the appropriate depreciation method and schedule.

Under Section 179 of the Internal Revenue Code (IRC), firms may expense (or deduct) up to $500,000 of the cost of qualified business property—mainly machinery, equipment, and standardized computer software—placed into service in 2013, and write off any remaining basis using the appropriate depreciation schedule under the Modified Accelerated Cost Recovery System (MACRS).[15] In 2014 and beyond, the maximum allowance will be set at $25,000.

Use of the allowance is subject to several limitations, the most important of which is the dollar limitation, which applies to total amount a company can expense in a tax year. Under the limitation, the maximum allowance is reduced (dollar for dollar) by any excess of the aggregate

[15] For more details on the current expensing allowance and its economic effects, see CRS Report RL31852, *Section 179 and Bonus Depreciation Expensing Allowances: Current Law, Legislative Proposals in the 113th Congress, and Economic Effects*, by (name redacted).

cost of qualified property a firm places in service during a tax year above a phaseout threshold. In 2013, the threshold is set at $2 million. This means that a firm may expense as much as $500,000 of its spending on qualified assets in the 2013 tax year, provided its aggregate spending for this purpose during the year remains below $2 million. Once the firm's total spending surpasses $2 million, the amount that can be expensed drops until total spending reaches $2.5 million, at which point none of that expense may be deducted under Section 179.

Congress established the expensing allowance mainly to serve two related purposes. One was to lower the cost of capital for relatively small companies. The other purpose was to stimulate increased business investment during periods of weak or negative economic growth.

It is because of the phaseout threshold that the expensing allowance mainly benefits firms that are relatively small in size. Large firms such as GM or Intel typically spend far more on assets that qualify for the allowance than the phaseout threshold.

In theory, the allowance can stimulate business investment in two ways. First, it can lower the user cost of capital for investment in qualified assets. This is because expensing produces a zero marginal effective tax rate on the returns to investment in those assets under the standard economic model for the determination of the user cost of capital.[16] Second, the allowance can increase the cash flow of firms using it. For firms whose cost of internal funds is lower than their cost of external funds such as loans or equity, a rise in cash flow may be critical to their ability to undertake new investments.

The impact of the allowance on the cost of capital was illustrated in a 1995 article by economist Douglas Holtz-Eakin. Among other things, he assessed the effect of the expensing allowance on a hypothetical firm's user cost of capital. **Table 2** summarizes his findings.[17] The first column shows the corporate tax rate; the second gives the required pre-tax rate of return if the entire cost of the investment is expensed; the third column provides the required pre-tax rate of return if the entire cost is recovered through the depreciation deductions allowed under federal tax law in the early 1990s; and the final column presents 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.

Two conclusions can be drawn from the results. First, expensing offered a significant investment subsidy that increased 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%, the reduction rose to 28%. Second, the user cost of capital under expensing declined as the tax rate increased because tax deductions were worth more at higher tax rates.

[16] See (name redacted), "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. In effect, under expensing, the after-tax rate of return on an investment becomes equal to the pre-tax rate of return. This happens because expensing reduces costs and after-tax returns by the same proportion, which is determined by the tax rate.

[17] Douglas Holtz-Eakin, "Should Small Businesses Be Tax-Favored?" *Tax Notes*, vol. 48, No. 3, September 1995, p. 389. (Dr. Holtz-Eakin served as Director, Congressional Budget Office, from 2003 to 2005.)

Table 2. Estimated User Cost of Capital Under-Expensing

(%)

Corporate Tax Rate	Expensing	Regular Depreciation	Absolute Size of the Subsidy
15%	17.95%	20.23%	2.28[a]
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*, September 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:

$c / q = (p - + \delta / 1 - \tau) \xi (1 - \tau \zeta)$, 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.

a. Percentage points, not percent.

In FY2013, according to the Joint Committee on Taxation, the allowance may produce a revenue loss of $4.4 billion.[18] But the allowance does not always produce a revenue loss. Its revenue effect generally hinges on the aggregate amount of investment in qualified assets in a particular tax year. In periods of rising business investment, the allowance is likely to generate substantial revenue losses because a significant share of the total cost of that investment is expensed. But the reverse is likely to occur in periods of declining investment, when the revenue gains from recent uses of the allowance exceed the revenue loss from new uses of it. Any shift from revenue loss to gain stems from the timing of depreciation deductions under current law. Firms that write off the entire cost of an asset in the year when it is placed in service by taking advantage of Section 179 can claim no additional depreciation allowances against any future income earned by the asset; in effect, they exchange a lower tax liability in the present for larger tax liabilities in the future. But companies making qualified investments can come out ahead, particularly in the case of relatively long-lived assets, since the present value of allowable depreciation deductions is greater with expensing than it is with less accelerated methods of depreciation.

Exemption of Certain Small Corporations from the Corporate Alternative Minimum Tax

Under current federal tax law, corporations above a certain receipt size 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, set of deductions and credits, and rules for the measurement of taxable income.

In general, for corporations subject to the top two marginal tax rates (34% and 35%), the AMT applies a lower marginal rate to a broader tax base. It expands the corporate tax base by adding a number of tax preferences from the regular income tax to taxable income under the AMT. In addition, most tax credits allowed under the regular income tax cannot be used to reduce AMT

[18] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13 (Washington: 2013), table 1.

liability. The AMT originated with the Tax Reform Act of 1986 and is mainly intended to ensure that all profitable corporations pay at least some federal income tax.

As a result of the Taxpayer Relief Act of 1997 (P.L. 105-34), certain small corporations have been exempt from the AMT since 1998. Eligibility generally is determined by a corporation's average annual gross receipts in the previous three tax years. But corporations formed after 1998 are exempt from the AMT in their first year with taxable income, 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 (say 2010 to 2012), and as long as their average annual gross receipts do not exceed $7.5 million in each subsequent three-year period (e.g., 2012 to 2014 and 2015 to 2017, etc.). Once a corporation loses its eligibility, it becomes subject to the AMT in that tax year and each one thereafter, regardless of the amount of its gross receipts. While exempt firms do not have to compute their AMT liability, they are required to pay the regular corporate income tax if their taxable income is positive.

The exemption may give eligible corporations a slight competitive advantage over firms comparable in size that pay the AMT. A 1997 study by economist Andrew Lyon found that firms that invested heavily in machinery, equipment, and intangible assets like research and development (R&D), financed the bulk of their investments through borrowing, and paid the AMT five or more years in a row had a higher cost of capital than comparable firms that paid the regular income tax throughout the same period.[19]

In addition, the exemption gives owners of small firms an incentive to incorporate, since the taxable income of passthrough entities might be subject to the individual AMT through the tax returns filed by owners.

In a 2000 report reviewing the IRS's implementation of changes in the taxation of corporations enacted from 1996 to 1998, the Treasury Department's Inspector General for Tax Administration (TIGTA) disclosed a few unexpected problems with the implementation of the exemption during the 1998 tax year. Specifically, TIGTA estimated that 93% of the 2,343 small corporations that paid the AMT that year qualified for the exemption. As a result, the exempt firms made over $25 million in erroneous AMT payments.[20] The report attributed the mistake to the numerous changes in the corporate AMT made by the Taxpayer Relief Act of 1997 and the "short time" available to taxpayers and tax professionals to understand the changes and apply them in preparing 1998 tax returns. TIGTA recommended that the IRS take certain steps to increase taxpayer awareness of the exemption, explain how it was supposed to work, and contact taxpayers who erroneously paid the AMT so they could file amended tax returns. In a follow-up study issued in 2003, TIGTA noted that though the IRS had taken most of those steps, it had not done enough to notify the 3,600 or so small companies that may have made over $37 million in erroneous AMT payments between 1998 and 2000.[21]

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[19] Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Washington: Brookings Institution Press, 1997), pp. 77-97.

[20] U.S. Department of the Treasury, Inspector General for Tax Administration, *More Small Corporate Taxpayers Can Benefit from the Alternative Minimum Tax Exemption Provision*, no. 2001-30-019 (Washington: November 2000), p. 4.

[21] Treasury 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), p. 2.

Amortization of Business Start-Up Costs

A key concept underlying the federal income tax is that taxable income should exclude all costs incurred in earning it. As a result, companies are allowed to deduct as current expenses all ordinary and necessary costs paid or incurred in conducting a trade or business in determining their taxable income. The concept also implies that costs paid or incurred in starting or organizing a business should not be treated as current expenses, as they are not directly related to the generation of income. Rather, because these expenses are incurred in an attempt to create a capital asset (namely, the business) with a useful life that is likely to extend beyond a single tax year, they should be capitalized, added to the owner's basis in the business, and recovered when the business is sold or ceases to exist.

IRC Section 195 (as amended by the American Jobs Creation Act of 2004 or AJCA, P.L. 108-357) deviates from this principle by permitting business taxpayers who incur business start-up and organizational costs after October 22, 2004 to deduct up to $5,000 of those costs in the year when the new trade or business begins to earn revenue. This deduction is reduced, dollar for dollar (but not below zero), by the amount by which eligible expenditures exceed $50,000. Expenditures that cannot be deducted may be amortized over 15 years, beginning in the first month the new trade or business earns income. In order to claim the $5,000 deduction, a taxpayer must have an equity interest in the trade or business and actively participate in its management.

The Small Business Job Creation Act of 2010 (P.L. 111-240) raised the deduction to $10,000 and the phaseout threshold to $60,000 for qualified start-up and organizational expenses incurred or paid in 2010 only. These higher amounts have not been extended.

To qualify for the deduction, start-up and organizational costs must meet two requirements. First, they must be paid or incurred as part of an investigation into creating or acquiring an active trade or business, as part of starting a new trade or business, or as part of an effort to produce income or profit before starting a trade or business with the aim of converting the effort into an active trade or business. Second, the costs must be similar in kind to costs that would be deductible if they were paid or incurred in connection with the expansion of an active trade or business in the same industry.

Start-up expenses that cannot be deducted can be amortized over 180 months, starting in the month when the trade or business begins. This was the only option for cost recovery before the enactment of AJCA. Businesses that incurred or paid business start-up and organizational costs and then entered a trade or business on or before October 22, 2004 were allowed to amortize (or deduct in equal annual amounts) those expenditures over five or more years, beginning in the month when the new trade or business commenced.

The option to deduct as much as $5,000 in business start-up and organizational costs in the first year of operation is intended to benefit new small firms. It permits the owner of such a firm to deduct expenses in the year when the business begins; without such a provision, the expenses could not be recovered until the owner sells his or her interest in the business or five years after the business started, whichever comes first. Thus, the option accelerates the recovery of certain ordinary and necessary business costs, and this acceleration can aid the growth of small start-up firms by reducing their cost of capital and increasing their cash flow at a time when their access to debt and equity markets may be severely restricted. For firms that lose money in their first year

of operation, the deduction can increase their net operating losses, which may be carried forward up to 20 years and used to offset future taxes paid or owed.[22]

Cash-Basis Accounting

IRC Section 446 requires firms to compute their taxable income using the same method of accounting they regularly employ in keeping their books, provided that method clearly reflects income for tax purposes. For a business taxpayer's method of accounting to clearly reflect income, it must treat items of income and deductions consistently from one tax year to the next. Permissible methods of accounting include the cash-receipts method, the accrual method, the installment method, the long-term-contract method, the crop method, the special methods for research and development expenditures, and the method for soil and water conservation expenditures.

Two methods of financial accounting are widely used in the private sector: cash-basis and accrual-basis. Under the former, 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 or the expenses are actually incurred.

Under accrual-basis accounting, 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 records expenses when the amounts are fixed and its liability for them is established.

Each accounting method has its own advantages. Cash-basis accounting is much simpler to administer and allows firms that employ it to control the timing of items of income or deductions. In contrast, 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.

Under certain circumstances, the accrual method must be used for tax purposes. When holding an inventory is necessary to the operation of a business, a taxpayer is required to use the accrual method in computing taxable income ─ unless the IRS determines that another method clearly reflects income and authorizes its use. Inventories are considered necessary when a firm earns income from the production, purchase, or sale of merchandise. In addition, C corporations, partnerships with C corporations as partners, trusts that earn unrelated business income, and authorized tax shelters generally are required to use the accrual method of accounting.

But there are some exceptions to these rules. Any partnership or C corporation with average annual gross receipts of $5 million or less in the three previous tax years may use the cash method of accounting. Individuals, S corporations, and qualifying partnerships and personal service corporations also have the option of using the method. And even though purchases and sales of inventory items cannot be reported for tax purposes using the cash method, the IRS has made an exception for sole proprietorships, S corporations, and partnerships that reported average annual

[22] Under the American Recovery and Reinvestment Act of 2009 (P.L. 111-5), eligible firms with net operating losses in the 2008 tax year may carry them back up to five years. Only firms with average annual gross receipts in the past three tax years of less than $15 million may take advantage of this expanded carryback.

gross receipts of $1 million or less in the three previous tax years (IRS Rev. Proc. 2001-10), regardless of the nature of their trade or business. The cash method may also be used by firms with average annual gross receipts of $10 million or less in the three previous tax years whose main business is providing services or fabricating products according to customer designs or specifications (IRS Rev. Proc. 2002-28).

As these exceptions indicate, many of the eligible firms are relatively small in receipt size. In effect, this method offers the same benefit to small firms as the expensing allowance under IRC Section 179 does: the deferral of income tax payments. The federal tax code operates in part on the principle that a firm receives income when it gains the legal right to be paid for something it has provided. But under the cash method, firms have greater control over the timing of receipts and payments of expenses than they do under the accrual method. This means that firms using the cash method have the option of deferring the payment of taxes or taking advantage of lower tax rates by shifting deductions and the recognition of income from one tax year to the next.

Despite the possible tax benefits to eligible small firms from using the cash method, it may not be in their self-interest to do so if they need to issue accurate and reliable financial reports. Cash-basis accounting can distort a firm's financial position in at least two ways.[23] First, because it records transactions involving only cash or its equivalent, the method excludes 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. Small firms seeking to raise capital in debt or equity markets may be better off using accrual-basis accounting.

Tax Incentives for Private Equity Investment in Small firms

Several tax provisions benefit smaller enterprises by encouraging equity investment in qualified small start-up firms that otherwise may have trouble raising needed funds. The provisions, which are described below, do so by increasing the potential after-tax returns or reducing the potential after-tax losses on such investment. The same tax benefits are not available to individuals investing in larger firms.

Partial Exclusion of Capital Gains on Eligible Small Business Stock

Two important considerations in determining the income tax liability for many individuals 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 a capital asset such as a stock or bond is sold or exchanged. If the selling price is greater than the acquisition or purchase price, the transaction produces a capital gain. Conversely, a capital loss results when the selling price is the lower of the two.

Capital assets held longer than 12 months and then sold or exchanged give rise to what are known as long-term capital gains or losses, whereas sales or exchanges of capital assets held one year or

[23] See Robert Libby, Patricia A. Libby, and Daniel G. Short, *Financial Accounting* (Chicago: Irwin, 1996), p. 111.

less generate short-term capital gains or losses. Short-term capital gains are considered ordinary income and taxed at regular income tax rates. By contrast, long-term capital gains are considered capital income and taxed in 2013 at 20% for individual taxpayers subject to marginal income tax rates of 39.6%; 15% for taxpayers taxed at 35%, 33%, 28%, and 25%; and 0% for individual taxpayers in the 10% and 15% income tax brackets.

IRC Section 1202 allows non-corporate taxpayers (including partnerships, LLCs, and S corporations) to exclude a specified portion of any gain from the sale or exchange of qualified small business stock (QSBS) that has been held for a minimum of five years and a day. For QSBS acquired in 2013, the exclusion is 100%, under a provision of the American Taxpayer Relief Act of 2012 (P.L. 112-240). It reverts to 50% starting in 2014 (or 60% if the QSBS is issued by a qualified firm based in an empowerment zone and acquired during the 2014 to 2016 tax years.

There is a cumulative limit on the gain from stock issued by a single corporation that may be excluded. In any tax year, the gain cannot exceed the greater of 10 times the taxpayer's adjusted basis in all QSBS issued by the same firm that he sold or exchanged during the year or $10 million—reduced by any gains from sales of the stock by the taxpayer that were excluded in previous years. Any remaining gain is taxed at a fixed rate of 28%. This means that the marginal effective tax rate on capital gains from the sale or exchange of QSBS held longer than five years is 0% when the exclusion is 100% and 14% when it is 50% (0.5 x 28%).

For individuals subject to the AMT, a portion of the excluded gain is considered an individual AMT preference item. In essence, the AMT recaptures certain tax savings under the regular income tax by requiring high-income taxpayers to modify their regular taxable income by taking into account certain preference items and adjustments. Tax preference items, including portions of deductions and exclusions from income, are added to the taxpayer's taxable income for the calculation of the AMT. The recaptured portion is 7% for QSBS acquired after May 6, 2003, which means that only 3.5% of any recognized gain is treated as a tax preference item when the exclusion is 50%.[24]

To qualify for the partial exclusion, small business stock must satisfy several requirements. First, it must be issued after August 10, 1993 and 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 issuing corporation. Second, the stock must be issued by a domestic C corporation whose gross assets do not exceed $50 million up to the time the stock is issued and immediately afterwards. Third, at least 80% of the corporation's assets must be employed in the active conduct of one or more qualified trades or businesses during "substantially all" of the requisite five-year holding period. Assets used for working capital, start-up activities, or research and development meet the active business test, even if they are devoted mainly to the development of future lines of business. Specialized small business investment companies licensed under the Small Business Investment Act of 1958 also meet the active business test, making their stock eligible for the partial exclusion.

Stock issued by C corporations with less than $50 million in gross assets that are primarily engaged in one or more of the following commercial activities does not qualify for the exclusion:

[24] For QSBS acquired after February 17, 2009, and before September 28, 2010, the exclusion is 75%, so 5.25% of any recognized gain is treated as a tax preference item; and for stock acquired after September 27, 2010, and before January 1, 2014, the exclusion is 100%, so none of the excluded gain is a tax preference item.

health care, law, engineering, architecture, hospitality, farming, insurance, finance, and mineral extraction. Nor does stock issued by the following small C corporations: 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 mainly intended to improve the access of small start-up firms in a variety of industries to so-called patient equity capital. It accomplishes this by increasing the potential after-tax returns an investor can earn on purchases of QSBS, relative to the potential after-tax returns on similar investment opportunities, over five years. Under current law, the maximum capital gains rate is 20% and the exclusion is 100% of realized gains from QSBS acquired in 2013. A full exclusion yields an effective capital gains tax rate for QSBS of 0%. This advantage is scheduled to narrow considerably starting in 2014, when the exclusion decreases to 50%, making the effective capital gains rate for QSBS 14%. Supporters of the partial exclusion say it is needed to compensate for the uncertainty that surrounds the growth prospects of new start-up firms in industries where sizable upfront investments in research and development are critical to their survival and expansion.

There is some evidence that the partial gains exclusion reduces the cost of capital for eligible C corporations issuing QSBS. In a 1999 study of the issue prices for such stock immediately before and after the enactment of Section 1202, David Guenther and Michael Willenborg found that the issue prices of QSBS issued by a sample of eligible firms after the tax change were "significantly higher than the issue prices before the change.[25] Meanwhile, there was no significant different in issue prices for a sample of firms that were ineligible to issue QSBS because of the size of their gross assets. They interpreted the results to mean that nearly all future benefits from the capital gains rate reduction were being passed on to issuing corporations in the form of higher stock prices, instead of being retained by investors. All other things being equal, rising stock prices lower a firm's cost of capital.

Still, not everyone thinks the gains exclusion is a good idea. Alan Viard of the American Enterprise Institute, while recognizing the efficiency benefits of offsetting part of the tax benefit for the use of debt to finance new investments, has criticized it on the grounds that its limitations distort the allocation of investment capital. As he noted in a 2012 article, the tax preference applies to very small companies in certain industries only, not to large companies and all industries, and may be claimed by certain investors only, not by all investors.[26] The many rules governing the use of the exclusion further dampen its potential economic benefits.

Losses on Small Business Investment Company Stock Treated as Ordinary Losses without Limitation

Generally, losses on investments in stock are treated as capital losses for tax purposes. They may be used to offset any capital gains in the same tax year. Individuals may also use any combination

[25] David A. Guenther and Michael Willenborg, "Capital Gains Tax Rates and the Cost of Capital for Small Business: Evidence from the IPO Market," *Journal of Financial Economics*, v. 53, 1999, p. 401.

[26] Alan D. Viard, "The Misdirected Debate and the Small Business Stock Exclusion," *Tax Notes*, February 6, 2012, p. 741.

of short-term and long-term capital losses to offset up to $3,000 in 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 their ordinary income all losses from the sale or exchange or worthlessness of stock in these companies. This exception from the general rule is intended to foster equity investment in these companies by lowering the potential after-tax loss on an investment in an SBIC, relative to the potential after-tax loss on other comparable 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 a net worth of less than $18 million and an average net income of less than $6 million in the previous two years. These entities use their own capital and funds borrowed at favorable rates as a result of SBA loan guarantees to make equity and debt investments in qualified firms. For tax purposes, most SBICs are treated as C corporations.

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 tax year when they are realized.

But under IRC Section 1044, individual and corporate taxpayers who satisfy certain conditions may roll over, tax-free, any capital gains on the sale of publicly traded securities. The gains 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 with one exception: SSBICs are required to invest in small firms owned by individuals considered socially or economically disadvantaged—mainly members of designated minority groups.

If the gains exceed the acquisition cost of the SSBIC stock or partnership interest, the excess is recognized as a short-or long-term capital gain and taxed accordingly. The taxpayer's basis in the SSBIC stock or partnership interest is reduced by the amount of any gain that is rolled over. There is a limit on the gain an individual can roll over in a single tax year: the lesser of $50,000 or $500,000 less any gains previously rolled over under Section 1044. For C corporations, the maximum deferral in a tax year is the lesser of $250,000 or $1 million less any previously deferred gains.

Ordinary Income Treatment of Losses on Sales of Small Business Stock

IRC Section 1244 allows taxpayers to treat any loss from the sale, exchange, or worthlessness of qualified small business stock as an ordinary loss rather than a capital loss. For business taxpayers, ordinary losses are treated as business losses in computing a net operating loss.

To qualify for this treatment, stock must meet four requirements. First, it must be issued by a small business corporation after November 6, 1978. A small business corporation is defined as a domestic C corporation whose cash and property received as a contribution to capital and paid-in surplus totals less than $1 million at the time the stock is issued. Second, the stock must be acquired by an individual investor or a partnership in exchange for money or other property (but not stock and securities). Third, during the five tax years before a loss on the stock is recognized,

the small business corporation must derive more than 50% of its gross receipts from sources other than royalties, rents, dividends, interest, annuities, and stock or security transactions. The amount that may be deducted as an ordinary loss in a tax year is capped at $50,000 ($100,000 for a couple filing jointly).

Uniform Capitalization of Inventory Costs

Firms that earn income from the production, purchase, or sale of merchandise are required to maintain inventories in order to account for the cost of goods sold during a tax year. This cost is subtracted from gross receipts in the computation of taxable income. In most cases, the cost of goods sold is determined 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 that amount from 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" (i.e., 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 rule is known as the uniform capitalization rule and was added to the tax code by the Tax Reform Act of 1986. In general, direct costs are considered the material and labor costs related to the production or acquisition of goods, and indirect costs refer to all other costs incurred through 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 assigning indirect costs to production or resale activities, provided the methods used to allocate the costs yield reasonable and defensible results for the trade or business.

Some small firms, however, are exempt from the uniform capitalization rule. Specifically, it does not apply to firms that acquire tangible or intangible property for resale and that had average annual gross receipts of $10 million or less in the three previous tax years. The exemption is beneficial for three reasons. Eligible firms have lower administrative costs, face less complexity in complying with income tax laws, and can exercise more control over the timing of business expense deductions, opening up opportunities for the deferral of income tax liabilities.[27]

Simplified Dollar-Value LIFO Accounting Method for Small Firms

Business taxpayers that maintain inventories to account for the cost of goods sold are required to estimate the value of their inventories at the beginning and end of each tax year. Since doing this item by item is time-consuming and costly, many taxpayers use estimation methods that assume certain item or cost flows.

One such method is known as "last-in-first-out" (or LIFO). LIFO operates on the assumption that the most recently acquired goods are sold before all other goods. Consequently, LIFO assigns the most recent unit costs to the cost of goods sold and the oldest unit costs to the remaining inventory at the end of the year. The method can be advantageous during periods when the cost of many inventory items is rising, for it yields a lower taxable income and inventory valuation than

[27] See Paul G. Schloemer, "Simplifying the Uniform Inventory Capitalization Rules," *Tax Notes*, vol. 53, no. 9, December 2, 1991, pp. 1065-1069.

other methods. There are various ways to apply LIFO. A widely used application is known as the dollar-value method. Under it, a taxpayer accounts for the value of its inventories on the basis of a pool of dollars rather than a pool of specific items. Each dollar pool includes the value of a variety of inventory items and is measured by the dollar value of the items in the base year, which is the year when they were first added to the inventory. Use of the dollar-value method is complicated and costly and thus beyond the reach of most business taxpayers.[28]

But IRC Section 474, which was added to the tax code by the Tax Reform Act of 1986, allows certain small firms to 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 in the technique for estimating the base-year value of the pooled items. Firms with average annual gross receipts of $5 million or less in the three previous tax years are permitted to use the simplified method.

Non-Refundable Tax Credit for Pension Plan Start-Up Costs of Small Firms

Under IRC Section 45E, qualified small firms may claim a non-refundable tax credit for a portion of the start-up costs incurred 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 originally was scheduled to expire (or "sunset") at the end of 2010. But a provision of the Pension Protection Act of 2006 permanently extended the credit. It is a component of the general business credit under IRC Section 38 and thus subject to its dollar 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 a qualified pension plan is operative. Eligible costs consist of the ordinary and necessary expenses associated with administering the plan and informing employees about the plan's benefits and requirements. Any new defined benefit or defined contribution plan, savings incentive match plan for employees, or simplified employee pension plan qualifies for the credit. Only firms with fewer than 100 employees, each of whom received at least $5,000 in compensation in the previous year, are allowed to claim the credit, provided at least one highly compensated employee participates in the plan.

In effect, the credit gives owners of small firms an incentive to establish pension plans for employees by lowering the after-tax cost of setting up and administering these plans over the first three years they are available. Supporters of the credit say the reduced cost should spur increased plan sponsorship among small employers. As a 2010 report issued by the SBA made clear, startup costs can be considerable on a per-employee basis for companies with relatively few employees.[29] Yet available data on pension benefits by employer size offer no clear evidence that the credit has had its intended effect on the share of small employers offering pension plans. According to figures released by the Employee Benefit Research Institute (EBRI), the percentage of firms with fewer than 100 employees sponsoring pension plans was lower in 2011 than it was in 2002, the

[28] 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.

[29] See Kathryn Kobe, *Small Business Retirement Plan Availability and Worker Participation* SBA Office of Advocacy, contract no. SBA-HQ-06M0477 (Washington: March 2010), p. 22.

first year the credit was available.[30] And in an annual survey of small employer retirement plans that was discontinued after 2003, EBRI found that none of the new sponsors of retirement plans in 2003 said the credit was a major reason why they chose to do so, and a only a few cited it as a minor reason.[31] The most influential motivations for sponsoring a plan, according to the survey, were that it would have a "positive impact on their (the employers') ability to attract and retain quality employees and on the attitude and performance of their employees."

Non-Refundable Tax Credit for Expenses Incurred in Making a Business More Accessible for Disabled Persons

Under IRC Section 44, an eligible small firm may claim a non-refundable tax credit for expenses incurred in making its business facilities more accessible for disabled individuals. The credit is equal to 50% of eligible expenditures in a tax year above $250 but not greater than $10,250; it is capped at $5,000 for a single taxpayer in a tax year. In the case of a partnership, this upper limit applies separately at the partnership level and at the partner or individual level; this rule also applies to the shareholders of a subchapter S corporation. The disabled-access credit is a component of the general business credit under IRC Section 38 and thus subject to its limitations.

To qualify for the credit, a firm must satisfy one of two requirements concerning its previous tax year: either its gross receipts (less any returns and allowances) that year totaled no more than $1 million, or its full-time equivalent (FTE) work force did not exceed 30 persons. A worker is considered an FTE employee if he or she works at least 30 hours a week for 20 or more weeks in a calendar year.

Any amount an eligible small firm pays or incurs to bring its business into compliance with the Americans with Disabilities Act of 1990 (ADA) qualifies for the credit. The expenses must be reasonable in amount and required by law. Eligible expenses include those related to removing architectural, communication, transportation, or physical barriers to making a business accessible to or usable by disabled individuals; providing interpreters or other effective methods of making materials understandable to hearing-impaired individuals; and supplying qualified readers, taped texts, and other effective methods of making materials understandable to visually impaired individuals.

The credit is intended to lower the net cost to smaller firms of complying with the mandates of the ADA and to encourage them to hire more disabled persons. Although the credit has been available for over two decades, it remains unclear how effective it has been in stimulating increased business investment in making workplaces more accommodative to the special needs of disabled persons seeking employment. In a 2002 report, the then-named General Accounting

[30] In 2011, according to an EBRI report, 13.8% of firms with fewer than 10 employees sponsored pension plans; the share in 2002 was 16.5%; for firms with 10 to 49 employees, the 2011 share was 29.6%, and the 2002 share 31.4%; and for firms with 50 to 99 employees, the 2011 share was 43.4%, and the 2002 share 46.9%. See Employee Benefit research Institute, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2011," *Issue Brief*, no. 378 (Washington, November 2012), Figure 2, p. 11; and "Employment-Based Retirement and Pension Plan Participation: Declining Levels and Geographic Differences," *Issue Brief*, no. 262 (Washington: October 2003), Figure 2, p. 7.

[31] Employee Benefit Research Institute, *The 2003 Small Employer Retirement Survey (SERS): Summary of Findings*, p. 1.

Office (GAO) noted that it could find no studies of the effectiveness of the credit and that few businesses were even aware of it.[32] It appears that no such studies have been done since 2002.

Non-Refundable Tax Credit for Employee Health Insurance Expenses

The Patient Protection and Affordable Care Act (ACA, P.L. 111-148) added a new provision to the federal tax code (IRC Section 45R) that grants certain small employers a tax credit for non-elective contributions to health plans that cover at least 50% of the cost for participating employees. An employer's contribution is considered non-elective if it does not involve a reduction in participating employees' salaries or wages.

Eligible employers have been able to take the credit since the 2010 tax year. From 2010 through 2013, the maximum credit is equal to 35% of the *lesser* of the total amount of an employer's non-elective contributions during a tax year for the payment of qualified health insurance for its employees through a "contribution arrangement," or the total amount of non-elective contributions that would have been made if each employee had enrolled in a qualified health plan with a premium equal to the average premium for the small-group market in the state where the employer is located. Under such a scheme, an employer may not claim the credit for the portion of employer-paid premiums above the average premium for the small-group market where the employer is located.

Employers with 25 or fewer full-time employees earning an average annual compensation of $50,000 or less can benefit from the credit, but the full credit may be claimed only by employers with 10 or fewer full-time employees whose average annual compensation is $25,000 or less. The credit phases out by 6.667% for each full-time employee above 10, and by 4% for every $1,000 in average annual compensation above $25,000.

For tax years beginning in 2014, an eligible employer may claim the credit no more than two consecutive tax years (e.g., 2014 and 2015) if it offers one or more qualified health plans through a state-based health insurance exchange. Each state is supposed to establish such an exchange by the start of 2014, and there are several options for organizing and operating one. The maximum credit for tax years after 2013 will be equal to 50% of the *lesser* of the total amount of employer contributions for qualified health plans offered through an exchange, or the total amount of employer contributions that would have been made that year if each employee had enrolled in a qualified health plan with a premium equal to the average premium for the small-group market in the rating area where the employees receive coverage. Once again, the credit will not apply to premiums deemed excessive.

Several rules governing the use of the credit can affect its effective rate. The credit is a component of the general business credit (GBC), and thus subject to its limitations. Unused GBCs may be carried back one year or forward up to 20 years. Any credit not used by the end of the 20-year carry-forward period may be deducted in its entirety in the next tax year. Since 2011, employers have been able to take the credit against both the regular income and alternative minimum taxes. But to prevent employers from deriving two tax benefits from the same

[32] U.S. General Accounting Office, *Incentives to Employ Workers with Disabilities Receive Limited Use and Have an Uncertain Impact*, GAO-03-39 (Washington: December 2002), p. 19.

expenditures, any employer taking the credit must reduce its deduction for employer-paid premiums by the amount of the credit.

In essence, the credit is intended to increase the share of employers with 25 or fewer low-wage employees providing health insurance to employees. It does so by lowering the after-tax cost of coverage by as much as 35% from 2010 to 2013 and by as much as 50% in two consecutive years starting in 2014 for firms with sufficient tax liability.

Congress added the credit to ACA in part to address a longstanding concern about the extensive web of employer-provided health insurance. While the vast majority of large employers offer health benefits to employees, a much smaller share of small employers do so, and the share is even smaller for small employers with mostly low-wage workers. According to the latest survey of employer health benefits by the Henry J. Kaiser Family Foundation (KFF) and the Health Research and Educational Trust (HRET), 98% of employers with 200 or more employees offered health benefits in 2012, compared with 61% of employers with 3 to 199 employees and 50% of employers with 3 to 9 employees. Among all the employers surveyed, regardless of their employment size, 64% of those with relatively low ratio of low-wage workers (defined as those earning $24,000 or less) to total workers offered health benefits, whereas only 28% of those with a relatively high ratio did so.[33]

With tax return data for one year only (2010), it would be premature to come to any conclusion about the effectiveness of the credit in boosting health insurance offer rates among eligible small firms. Still, if those results are any indication, the credit does little to boost the health insurance offer rates of small employers.

In an analysis of claims for the credit in the 2010 tax year, the Government Accountability Office (GAO) found that about 170,300 small employers claimed the credit out of a potential pool of 1.4 million to 4.5 million businesses;[34] the total amount claimed came to $468 million, less than 25% of initial revenue estimates by the Congressional Budget Office and the Joint Committee on Taxation. Most of the claims (83%) fell short of the maximum credit; 68% of the employers filing those claims did not qualify for the full credit because they did not meet the average wage requirement. Two considerations deterred many of the small employers GAO contacted from offering health benefits in response to the credit: (1) future rises in the cost of health insurance and (2) the recordkeeping requirements and numerous forms for claiming the credit.[35]

The KFF/HRET 2012 survey of employer health benefits provides additional support for the view that the credit may not be living up to its expected efficacy when it was enacted in 2010. The health insurance offer rate among employers with three to nine workers dropped from 59% in 2010 to 48% in 2011 and then rose to 50% in 2012.[36] It appears that other factors were exerting a

[33] Henry J. Kaiser Family Foundation and Health Research & Educational Trust, *Employer Health Benefits 2012 Annual Survey*, (Washington: September 11, 2012, pp. 36 and 38.

[34] U.S. Government Accountability Office, *Small Employer Health Tax Credit: Factors Contributing to Low Use and Complexity*, GAO-12-549 (Washington: May 2012), p. 9.

[35] Ibid., p. 12.

[36] Henry J. Kaiser Family Foundation and Health Research and Educational Trust, *Employer Health Benefits 2012 Annual Survey, p. 36.*

stronger influence on that rate, especially the cost of insurance, the size of the firm, and employee coverage under other health plans.[37]

Economic Importance of Small Firms

It is widely believed that small firms make significant contributions to the U.S. economy. How can that claim be verified? As with any assessment of the economics of small business, the starting point has to be the definition of a small business. The observable economic importance of small companies hinges on how and where the line is drawn between small firms and all other firms. Available small business data can be manipulated to validate or refute the claim that small firms make significant contributions to overall economic activity, depending on how a small firm is defined.

If small firms are defined as independent business enterprises with fewer than 500 employees, as the SBA does in compiling the economic data on small business it releases to the public, there is no question that they play a major role in the U.S. economy. In 2010, according to the SBA, firms of that size accounted for 99.7% of employers, employed about 49% of private non-farm workers, and were responsible for 43% of total payroll in the private sector.[38] A 2007 study funded by the SBA concluded that from 1998 to 2004, firms with 500 or fewer employees accounted for about 50% of nominal gross domestic product (GDP).[39] And according to data from the Bureau of Labor Statistics (BLS), firms with fewer than 500 employees accounted for 65% of the 15 million net new jobs created from 1993 to 2009. As research sponsored by the Center for Economic Studies at the U.S. Census Bureau has demonstrated, much of that job growth can be attributed to the creation of new small firms. A 2008 study done by John Haltiwanger and two colleagues found that new firms accounted for 3% of annual U.S. employment growth from 1987 to 2005; without their contribution, average annual net employment growth would have fallen by -1.2%. This finding indicated that existing firms (large and small in employment size) were a drag on net job growth in that period and whatever growth occurred was due to the formation of new firms.[40]

If a more restrictive definition of a small firm is used, however, a strikingly different picture of the economic importance of small business emerges. For example, a recent BLS study found that firms with fewer than 100 employees accounted for 45.0% of average quarterly net job growth from June 1990 to September 2005, while firms with fewer than 500 employees accounted for 63.7%.[41] And according to SBA data, firms with fewer than 20 employees accounted for 18% of private-sector jobs in 2007, while firms with fewer than 100 employees accounted for 35% and firms with fewer than 500 employees for 50%. If anything, these differences indicate the extent to which the economic role of small firms hinges on how those firms are defined. Their role can be inflated or deflated to suit a range of policy objectives, some of which are conflicting.

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[37] Ibid., p. 45.

[38] Small Business Administration, *Frequently Asked Questions*, updated September 2012, available at http://www.sba.gov/sites/default/files/sbfaq.pdf.

[39] Katherine Kobe, *The Small Business Share of GDP, 1998-2004*, report for the Small Business Administration (Washington: April 2007), pp. 7 and 13.

[40] John Haltiwanger, Ron Jarmin, and Javier Miranda, *Business Formation and Dynamics by Business Age: Results from the New Business Dynamics Statistics*, discussion paper, May 2008, p. 14.

[41] Jessica Helfand, Akbar Sadeghi, and David Talan, "Employment Dynamics: Small and Large Firms Over the Business Cycle," *Monthly Labor Review*, March 2007, p. 41.

Still, regardless of how a small business is defined, the economic role of small firms historically has exhibited several characteristics that distinguish them from larger firms. One is that the economic importance of small firms varies by industry. This is true in the case of output: in 2002, for example, the share of an industry's contribution to GDP attributable to firms with fewer than 500 employees ranged from 20% for information services to 85% for other services.[42] This is also true for employment: in 2007, among the 19 major industries recognized under the North American Industrial Classification System, the share of jobs held by firms with fewer than 500 employees ranged from 12% for the business management to 85% for other services and construction.[43]

In addition, only a small percentage of firms that start out small in employment size grow into large successful firms. According to the SBA, seven out of 10 new employer firms survive at least two years, half at least five years, a third at least 10 years, and a quarter at least 15 or more years.[44]

Finally, though hundreds of thousands of firms are formed each year, most are small in employment size, and their numbers are nearly matched by the number of firms that go out of business, most of which are also small. SBA data show that over 95% of firms that either started or failed between 1994 and 2008 had fewer than 20 employees.[45] About one-third of the jobs created and lost were due to the entry or exit of those companies.

Main Arguments For and Against Federal Support for Small Business

Available data indicating that small firms play a major role in domestic economic activity raise the question of why government assistance is needed when small firms typically account for substantial shares of employment and output and make important contributions to technological innovation over time.

The answer to this question is no trivial matter. Small firms may receive more than $11 billion in federal tax benefits in FY2013[46]—in addition to the subsidies they obtain through other federal programs targeted at small businesses. As with any expenditure, this support carries an opportunity cost in the sense of alternative uses of these funds and the effects. If it can be shown that existing government support for small business cannot be defended on economic grounds, then a case could be made that the United States would be better off using the funds for other purposes, such as investing in infrastructure expansion and modernization, research and development, or deficit reduction.

This section examines the chief arguments for and against government support for small businesses, including the support provided through the federal tax code. Most of the arguments

[42] Katherine Kobe, *The Small Business Share of GDP, 1998-2004*, p. 7.

[43] See http://www.sba.gov/sites/default/files/files/us_mi.pdf.

[44] Small Business Administration, *Frequently Asked Questions*, updated January 2011.

[45] See http://www.sba.gov/sites/default/files/dyn_us_tot_1.pdf.

[46] See **Table 1** beginning on p. 6.

focus on economic issues. But a few non-economic arguments are also made in favor of this support.

Arguments in Favor of Government Support

Proponents of government support for small business generally cite four reasons why they believe it is justified: (1) the special economic role played by small firms; (2) the barriers to their formation and growth in financial markets; (3) the impact of relatively high marginal tax rates on the formation and growth of small entrepreneurial firms, and (4) the unique opportunities for individual economic advancement associated with small business ownership. Each is examined below.

Special Economic Role of Small Firms

Many lawmakers cite the economic importance of small firms as a primary reason to support them through government programs and other subsidies. Two examples illustrate this argument. In remarks made on the Senate floor in 2001 endorsing legislation expanding federal financial support to small businesses, Senator Christopher Bond stated 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."[47] Similarly, in remarks made on the floor of the Senate in 2003, Senator Olympia Snowe urged her colleagues to back the creation of more tax benefits for small firms by noting that "they represent 99% of all employers, employ 51% of 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."[48] Read carefully, these statements suggest that small firms in general deserve federal support, not because they are suffering from the effects of some kind of market failure, but because they play an important role in economic activity.

Some proponents of government support for small business, however, take this line of reasoning a step further by arguing that small firms deserve such support because they generate economic benefits that larger firms generally cannot supply or emulate. These benefits, they say, can be seen in the multitude of jobs and new technologies small firms create over time, their innumerable and ever-changing linkages to larger firms in the industrial supply chain, and their unique contributions to economic renewal and growth. Proponents maintain that the net effect of these activities is to speed up the growth of the U.S. economy through improved productivity.

Job Creation

On the question of job creation, those who favor government support for small firms note that SBA data show that firms with fewer than 500 employees accounted for 52% of average annual private-sector employment and 70% of net job creation from 1980 to 2009.[49] The data also

[47] Sen. Christopher Bond, remarks in the Senate, *Congressional Record*, daily edition, vol. 147, January 25, 2001, p. S 576.

[48] Sen. Olympia Snowe, remarks in the Senate, *Congressional Record*, daily edition, vol. 149, no. 6, January 14, 2003, p. S299.

[49] Ian Hathaway and Albert Palacios, *Small Business and Job Creation: The Unconventional Wisdom*, Bloomberg Government Briefing, October 31, 2011, available at http://www.bgov.com.

indicate that though many small firms fail within five years of starting up, the survivors typically create enough jobs to offset those lost to firm exits, allowing many of the jobs created by new firms to persist.

Technological Innovation

On the question of technological innovation, proponents cite several findings from the recent literature on firm size and technological innovation. One study found that the contributions of small firms to innovation varied by industry, and that their contributions tended to be most important in relatively young industries where no firm had established substantial market power.[50]

Another study concluded that in certain industries, small start-up firms were more adept than large established ones at identifying promising commercial applications for new technologies and exploiting them. It found that during the 1980s and 1990s, there were many instances in which small start-up firms gained temporary advantages over larger established rivals in the commercial development of new technologies in biotechnology, microelectronics, computer software, and electronic commerce.[51]

A 2003 study by CHI Research, Inc. offers further evidence that small firms have made important contributions to the commercial development of new technologies. CHI Research found that firms with fewer than 500 employees held 41% of all patents filed by U.S. corporations from 1996 to 2000. The study also found that those firms received 13 to 14 times as many patents per employee as larger firms did.[52] Furthermore, the small firms filed 25% of the patents related to biotechnology, 19% of the patents related to pharmaceuticals, 11% of the patents related to medical equipment and electronics, and 9% of the patents related to chemicals other than pharmaceuticals.[53]

And a study of small business innovation in "green" technologies found that among all firms awarded 15 or more patents between 2005 and 2009, small firms were 16 times more productive than other firms. In this case, productivity was measured on the basis of the number of patent awards per employee. Innovative firms with fewer than 500 employees acquired an average of 27 patents per employee, compared to an average of 1.6 patents per employee for larger firms.[54]

Industrial Supply Chain

Proponents of government support for small business also contend that the support is deserved because of the special role many small firms play in the industrial supply chain. To substantiate this claim, they point to evidence that small firms tend to supply certain goods and services more efficiently than larger ones. For instance, economist Bo Carlsson noted in a 1999 study that such an efficiency edge was apparent in industries where large production runs and falling unit costs

[50] Joshua Lerner, "Small Business, Innovation, and Public Policy," in *Are Small Firms Important? Their Role and Impact*, Zoltan Acs ed., Kluwer (Academic Publishers: 1999), p. 160.

[51] Ibid., p. 160.

[52] CHI Research, Inc., *Small Serial Innovators: The Small Firm Contribution to Technical Change*, report for the Small Business Administration (Washington: 2003), p 3.

[53] Ibid., p. 17.

[54] Small Business Administration, Office of Advocacy, *Analysis of Small Business Innovation in Green Technologies*, no. 389, summary of findings (Washington: October 2011).

were the main drivers of competition and growth. Among the industries exhibiting this pattern were computers, automobiles, and steel.[55] In industries such as these, small and large firms tended to specialize in specific products or services. As a result, the two groups ended up interacting more as partners or suppliers than as competitors. In Carlsson's view, the dramatic rise in overseas outsourcing among large U.S. firms in the 1990s reinforced and deepened this informal division in labor between large and small firms. His research led him to conclude that small firms in general possessed at least one significant advantage over larger firms in the vast and complex supply chain that underpinned the U.S. economy. The advantage lay in the ability of small firms to act with greater flexibility and quickness in responding to new market opportunities and competitive threats.

Opportunities for the Economic and Social Advancement of Immigrants, Women, and Members of Minority Groups

Proponents of government support for small business also cite the financial and social benefits of small business ownership for women, minority groups, immigrants, and the communities where they live as a reason to provide such support.

They argue that owning and managing a small business gives them opportunities to increase their income and independence and to move into the economic mainstream of the United States. According to data from the American Community Survey by the Bureau of the Census, 18% of small business owners in 2010 were immigrants, and they employed 14% of all people working for small businesses that year.[56]

In addition, according to proponents, women-, minority-, and immigrant-owned small firms have benefits for their communities and society at large that go beyond job and wealth creation. There is evidence that female small business owners have done more than their male counterparts to encourage openness in workplace communication and decision-making, hire a diverse workforce, establish desirable child-care programs, and pay full benefits to employees. Families with self-employed women who work out of their homes seem more stable than the average family.[57] And among minority and immigrant groups, small business ownership helps to build tight-knit social networks, provide critical job and skills training, and establish informal local capital markets.[58]

Imperfections in Capital Markets

Yet another argument made in favor of government support for small businesses is that the subsidies can ease or offset the difficulties many current and aspiring small business owners encounter in trying to raise the capital needed to start or expand a business.

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[55] 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.

[56] David Dyssegaard Kallick, *Immigrant Small Business Owners*, Fiscal Policy Institute (New York: June 2012), p. 1.

[57] 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.

[58] 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.

If capital markets were truly efficient, every investment opportunity offering an after-tax rate of return greater than the cost of capital would be funded, regardless of the profitability, cash flow, size, or age of a firm. But proponents of government support for small business say that such a condition applies to relatively few small firms. In their view, many new small business owners have trouble borrowing from lending institutions or attracting equity capital mainly because lenders and investors lack the information required to evaluate the profit potential of the proposed venture. As a consequence, aspiring small business owners often have no choice but to finance projects out of their own resources or the resources of friends and family members, or, lacking access to those resources, to abandon the dream of owning their own business.

Proponents note that the problem of insufficient access to capital markets does not affect start-up companies only. Established small business owners may also have difficulty raising capital through borrowing or equity investment at times. According to proponents, a surge in small business failures since the start of the global financial crisis in 2008 illustrated this concern.

In light of these difficulties, proponents maintain that government support, especially loan guarantees and tax-favored instruments for equity investment, is needed to enable cash-strapped small firms to gain access to the funds they need to grow.

Cost of Tax Compliance

Proponents of government support for small firms point to the relatively high tax compliance costs borne by small firms as another reason to grant them some kind preferential treatment through the tax code, at least until the code can be simplified in ways that benefit small business owners. To substantiate this argument, they cite the results of a 2007 study that estimated federal tax compliance costs by various measures of the size of business. Among other things, the researchers found that the compliance burden, as measured by the time and money devoted to tax compliance per employee, was inversely proportional to the size of a business. Specifically, for the 2002 tax year, the estimated financial burden per employee ranged from $8,435 for firms with one to five employees down to $348 for firms with more than 50 employees.[59] Proponents maintain that such a large difference runs the risk of putting smaller firms at a competitive disadvantage against larger firms in the same industries.

Arguments Against Government Support

Not everyone agrees that government support for small business is justified on economic grounds. Critics of the preferences cite the findings of several recent studies as grounds for questioning the economic arguments made by proponents.

A key tenet of conventional economic analysis is that government intervention in the economy is warranted mainly to remedy a market failure. In general, such a failure can be thought of as a condition that prevents or hinders the emergence of economically efficient outcomes. Foremost among the market failures identified by economists as grounds for government intervention are:

[59] The financial burden is the per-employee sum of the monetized time and money spent on complying with federal taxes. Much of the time burden was given over to recordkeeping, while most of the monetary cost stemmed from hiring paid tax professionals. See DeLuca, Donald, John Guyton, Wu-Lang Lee, John O'Hare, and Scott Stilmar, "Estimates of U.S. Federal Income Tax Compliance Burden for Small Businesses," in *Proceedings of the 100th Annual Conference on Taxation*, Columbus, OH, 2007 (Washington: 2007), table 9, p. 80.

- lack of perfect competition,
- presence of public goods,
- positive or negative external effects (or externalities),
- existence of incomplete markets, and
- asymmetric (or imperfect) information on the part of consumers.[60]

Critics of government support for small businesses say there is no compelling evidence that one or more market failures stand in the way of their formation or growth. More specifically, they can find no evidence that chronic imperfections in capital markets are leading to the formation of too few or the failure of too many small firms, or that small firms in general generate unmatched external benefits. Therefore, say critics, in the absence of a verifiable market failure, government support (including tax subsidies) for small business may do more economic harm than good.

Equity Concerns

Proponents of small business tax preferences generally ignore their equity effects in defending them on economic grounds.

But to critics, those effects offer a key reason to reduce or repeal the preferences. In their view, small business tax preferences undercut the progressivity of the federal individual income tax. Under a progressive income tax, an individual's tax liability depends on his or her taxable income. As a result, taxpayers with higher taxable incomes pay a greater share of their income in taxes than taxpayers do with lower taxable incomes. Small business tax preferences, however, weaken the link between tax liability and income by lowering the tax burden on the earnings of small firms, the vast share of which are organized as passthrough entities. The earnings of such a business pass through to the owners and are taxed at their individual income tax rates.

Among public finance economists, it is assumed that individuals, not firms, ultimately bear the burden of business income taxes, or reap the benefits of business tax subsidies. Some critics of government support for small business argue that these benefits ultimately increase the after-tax earnings of small firms, and that the added earnings sooner or later raise the incomes of small business owners, whose incomes and wealth tend to be well above the average for U.S. households.[61] As a result, individuals with small business income who can take advantage of existing small business tax preferences would be likely to have lower tax burdens than individuals

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

[61] 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 from 1992 to 2001, researchers George W. Haynes and Charles Ou found that, in 2001, the mean income of households with small business owners was $110,370, compared to $42,108 for households with no business owners, and the mean net worth of households with small business owners was $1,050,872, compared to $188,535 for households with no business owners. (See George W. Haynes and Charles Ou, *How Did Small Business-Owning Households Fare During the longest U.S. Economic Expansion?*, report prepared for the Small Business Administration (Washington: June 2006) table 3, p. 26.

with the same taxable income but no small business income. Such a scenario exemplifies the way in which the preferences can lessen horizontal equity in the federal tax code.

Efficiency Concerns

Critics also find fault with small business tax subsidies on efficiency grounds. In theory, income taxes reduce social welfare by driving a wedge between the costs and benefits of the choices for consumption and production facing individual consumers and firms. As a result, economic analysis holds that the best possible tax system is one that raises needed revenue without distorting the allocation of economic resources among investment and consumption opportunities. The only tax that meets these requirements is a lump-sum tax: it would impose the same tax on all individuals, regardless of income or wealth.

Such a view has important implications for tax policy. First, it implies that the returns to all investments should be taxed at the same rate. Second, the idea that the optimal tax system is a lump-sum tax implies that any tax that is not uniform across business owners is likely to damage social welfare.[62] Finally, it implies that taxes should not distort a firm's choice of inputs or its investment or production decisions.

Small business tax preferences, say critics, violate each of these policy prescriptions. In their view, an efficient 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 certain asset, employment, or revenue size and grow no further.[63]

A departure from neutral taxation of capital income to assist small firms might be warranted if there were something uniquely or extraordinarily valuable about their economic role, and if small firms can play that role only through government support. Proponents of government support for small business address the issue by maintaining that small firms consistently create more jobs and generate more important technological innovations than larger firms, and that targeted government support is needed to ensure they continue to play these roles. Critics call into question both the premises and policy implications of this claim.

Special Economic Role of Small Firms

Critics disagree with the claim that such support is justified on the grounds that small firms perform special economic functions that larger firms cannot match or duplicate. Proponents say these functions involve job creation, technological innovation, the efficiency of the business supply chain, and economic renewal and transformation. According to critics, however, there is no evidence that small firms in general have a decisive long-term edge over larger firms in creating jobs, developing new marketable goods and services, improving the efficiency and productivity of the supply chain, and generating economic change and renewal. They also argue there is insufficient evidence that too few small firms are being created over time as a result of

[62] Stiglitz, *Economics of the Public Sector*, pp. 567-569.

[63] Douglas Holtz-Eakin, "Should Small Businesses be Tax-Favored?," *National Tax Journal*, vol. 48, no. 3, September 1995, p. 390.

systematic failures by private lenders and investors to provide adequate financing for start-up firms. Each of these issues is examined below.

Small Firms and Job Creation

Critics and proponents of government support for small business tend to agree that small firms are responsible for most job growth over time. After all, firms with 500 or fewer workers created 65% of all net new U.S. jobs from 1993 to 2009.[64]

But the two sides differ on the significance and policy implications of this contribution. As discussed earlier, proponents construe the large share of net new jobs attributed to small firms as a rationale for government support. Critics, on the other hand, say that share does not prove what proponents say it does.

To begin with, critics say that small firms are not consistently better at creating jobs than large firms. To substantiate this claim, they cite a 1994 study by David Birch and James Medoff of U.S. job creation. Birch and Medoff estimated that the share of the total number of net new jobs generated in the late 1980s and early 1990s by firms employing 100 or fewer workers varied from 40% to 140%, depending on the stage of the business cycle.[65]

Critics also say that among small firms, there is substantial variation in the number of net new jobs they create from one year to the next. Most jobs created by small firms originate in start-up firms, which typically begin small in employment size. According to a 2011 report by Ian Hathaway and Albert Palacios, firms in existence less than a year accounted for an average of about 3 million jobs per year from 1990 through 2009. By contrast, firms aged from one to five years lost an average of 622,000 jobs a year; firms aged from six to 10 years lost an average of 348,000 a year; and firms that had been in business 11 or more years lost an average of 574,000 a year.[66] This is to say that non-start-up firms lost an average of 1.5 million jobs a year in that period. Hathaway and Palacios also found that the average annual job creation from 1990 to 2009 among start-up firms was 2.906 million, whereas small firms aged one to five years lost an annual average of 703,000 jobs; those aged from six to 10 years lost an annual average of 401,000; and those aged 11 or more years lost an annual average of 849,000.[67] Relatively few start-up firms generated most of the job growth.

A 2010 study by economist John Haltiwanger and Ron Jarmin and Javier Miranda from the U.S. Census Bureau backed the findings of the Hathaway-Palacios study.[68] Haltiwanger, Jarmin, and Miranda used data from the Census Bureau Business Dynamics Statistics and Longitudinal

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[64] U.S. Small Business Administration, Office of Advocacy, *Frequently Asked Questions*, (Washington: January 2011).

[65] 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%.

[66] Hathaway and Palacios, *Small Business and Job Creation: The Unconventional Wisdom*, p. 8.

[67] Ibid., p. 11.

[68] See John C. Haltiwanger, Ron S. Jarmin, and Javier Miranda, *Who Creates Jobs? Small vs. Large vs. Young*, NBER working paper 16300 (Cambridge, MA: August 2010).

Database to test the widely held belief that net job growth over time is negatively related to firm size. The results confirmed the belief when the researchers did not control for the age of firms. But when they did, there no longer was a systematic relationship between firm size and net job growth. What emerged instead was a systematic relationship between gross and net job creation and the age of firms. More specifically, the results showed that start-ups accounted for disproportionately large shares of job creation and job destruction from 1992 to 2005. They also indicated that firms over 10 years old and with more than 500 employees accounted for 40% of job creation and destruction. Haltiwanger, Jarmin, and Miranda concluded from the findings that young firms exhibit an "up or out dynamic," meaning that they either grow fast or go out of business.

Birch and Medoff discerned a similar trend in their analysis of the small business jobs created during the late 1980s and early 1990s. They called the few firms responsible for this job growth "gazelles," as they grew swiftly from small to large.[69]

And a 1996 study involving Haltiwanger found there was no robust, systematic relationship between firm size and net job growth rates in the manufacturing sector during the 1970s and 1980s, although large firms and plants did dominate job creation and destruction.[70]

Critics also contend that even if small firms were to create more lasting jobs than large firms do over time, there would be no reason to expect government support for small business to generate faster employment growth. Economic analysis shows that the economy generates jobs through what can best be described as a natural process of growth, decline, and structural change. The size distribution of firms seems to be incidental, nothing more than a byproduct of this process. This implies that the level of national employment over time is the result of a mix of forces that are bound to overwhelm the employment effects of any government support for small business. Many economists would agree that the key forces include fiscal and monetary policy, consumer spending, business investment, and the difference between U.S. exports and imports.

Small Firms and Technological Innovation

Research and development (R&D) is the lifeblood of technological innovation, which, in turn, serves as a powerful engine of long-term economic growth and structural change. Economists generally agree that without government support, business investment in R&D would fall short of socially optimal amounts. Left to their own devices, firms are likely to invest too little in R&D for two reasons. First, they cannot capture all the returns to R&D investment, as other firms find ways to capitalize on the results of research despite patents and other forms of intellectual property protection. Second, some firms (mainly start-up firms) lack access to the funds needed to undertake planned R&D projects because potential lenders and investors lack the information needed to assess the projects' profit potential.[71] Economists generally view this predisposition to invest suboptimal amounts in R&D as a market failure because the external economic benefits (or positive externalities) from the investments seem to have little or no influence on the investment

[69] Birch and Medoff, "Gazelles," pp. 162-164.

[70] Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction* (Cambridge, MA: MIT Press, 1996), pp. 169-170.

[71] 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.

decisions of private companies. To remedy this shortcoming, many economists are inclined to call for the adoption of government measures aimed at spurring increased business R&D investment.

But critics of government support for small business maintain there is no good reason for targeting such support at small firms if the main intent is to spark faster rates of technological innovation. They note that small and large firms develop the new technologies that propel economic growth and encourage structural change. Moreover, say critics, it is often impossible to disentangle the contributions of smaller firms from larger ones. According to data from the National Center for Science and Engineering Statistics, larger firms typically perform the vast share of business R&D: in 2008 and 2009 combined, for example, companies with fewer than 500 employees accounted for a little more than 20% of the business R&D (measured in current dollars) conducted in the United States, whereas companies with 1,000 or more employees were responsible for nearly 76% of those investments.[72]

This is not to suggest that small and large firms are equally prolific at developing new commercial technologies. Available evidence indicates that the two groups have distinct advantages as agents of technological innovation.[73] On the one hand, small firms historically have had more success than their larger counterparts in using R&D to generate new industries and dominate the industries' early stages of growth; smaller firms may also be more flexible than larger firms in identifying and pursuing commercial applications for emerging innovations. On the other hand, large firms can more easily raise the funds needed to finance the substantial sunken costs involved in many research projects. They are also likely to capture a larger share of the returns to R&D investments through marketing campaigns, the use of intellectual property protection, and the creation of regional, national, and international distribution, service, and repair networks.

According to critics, another reason why small firms cannot be said to play a special and invaluable role in technological innovation comes from studies that have looked at the effects of firm size and market structure on innovation.[74] On the whole, the studies brought forth no evidence that a certain firm size is ideal for generating and disseminating new commercial technologies. Rather, their findings indicated that in some industries, small firms were more innovative than large firms, but in other industries, large firms had a decisive edge in the generation of new technologies.

Critics also point out that the vast majority of small business owners have no intention of developing a new idea and bringing it to the marketplace. A 2011 study by economists Erik Hurst and Benjamin Pugsley of the University of Chicago noted that only 10% of new businesses that participated in a 2006 survey conducted as part of a Panel Study of Entrepreneurial Dynamics II reported that they planned to develop "proprietary technology, processes, or procedures in the future."[75] Nearly 80% of the businesses indicated that they had no plans for research and development "to be a majority priority."

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[72] National Science Foundation, National Center for Science and Engineering Statistics, *Business R&D Performed in the United States Cost $291 Billion in 2008 and $282 Billion in* 2009, NSF 12-309 (Arlington, VA: March 2012), table 1, p. 1.

[73] See Wallsten, "Rethinking the Small Business Innovation Research Program," p. 197.

[74] F. M. Scherer and David Ross, *Industrial Market Structure and Economic Performance*, 3rd edition (Boston: Houghton Mifflin Co., 1990), pp. 651-657.

[75] Erik Hurst and Benjamin Wild Pugsley, *What Do Small Businesses Do?* August 2011, p. 25, available at (continued...)

Small Firms and the Productivity and Efficiency of the Business Supply Chain

Critics of government support for small business challenge the claim that small firms in general play critical roles in improving the efficiency of the business supply chain. In doing so, they again point to the findings of the study by Hurst and Pugsley. Among other things, they found that about half of the new small businesses surveyed intended to provide an existing product or service to an existing customer base and few showed much desire to grow into big firms or to innovate "in any observable way.[76]" When asked about their primary reasons for starting a new business, over half of the small business owners said that so-called "non-pecuniary benefits" played a leading role. These benefits included being one's own boss and having a more flexible work schedule.

According to Hurst and Pugsley, such behavior was consistent with the industries in which most small firms were concentrated. Using data from the Statistics of U.S. Businesses compiled by the U.S. Census Bureau, they found that two-thirds of small businesses in 2007 were either restaurants, skilled professionals (e.g., doctors, lawyers, accountants), skilled craftsmen (e.g., general contractors, electricians, plumbers), professional service providers (e.g., clergy, insurance agents, real estate agents), or small retailers (e.g., gas stations, pharmacies, grocery and clothing stores).

These findings call into question the validity of the argument that small firms deserve government support because they serve as vital agents for productivity growth and greater efficiency within the business supply chain. As Hurst and Pugsley have demonstrated, the typical small business has little or no interest in growing or inventing new commercial technologies that could be sold to large firms. And it is involved in providing existing goods and services to established customer bases in the areas they serve.

Small Firms and Economic Renewal and Change

Critics acknowledge that startup companies that turn into what Medoff and Birch called gazelles can exert a transformative pull on the fabric of markets and industries. Cases in point include Google, Microsoft, Facebook, and Intel. But they dispute the notion that small firms in general are critical to the processes of economic renewal and change. In their view the gales of creative destruction stirred by such innovative big companies as IBM, Walmart, and the grocery chain A&P have done as much as any gazelle to transform entire markets and industries, often to the benefit of consumers. Critics say that firms such as these are likely to do more to advance productivity growth and promote structural change over time than any group of small firms could do.

Other Policy Issues

Critics of government support for small business also contend that some of it poorly serves its intended purposes or is less effective than alternative approaches might be. Two issues are of

(...continued)

http://www.brookings.edu/~/media/Files/Programs/ES/BPEA/2011_fall_bpea_papers/2011_fall_bpea_conference_hurst.pdf.

[76] Ibid., p. 2.

particular concern: the impact of certain small business tax subsidies on employment growth and the incentive to grow.

Investment Subsidies and Small Business Employment

Critics maintain that if one of the aims of public policy is to stimulate small business employment growth, then it may be counterproductive to offer small firms subsidies that lower the cost of capital but not the cost of labor. The reason lies in the possible impact of an investment subsidy on a firm's demand for labor.

In essence, an investment subsidy like the Section 179 expensing allowance lowers the cost of capital relative to the cost of labor. In theory, this imbalance should encourage profit-maximizing small firms to substitute qualified capital assets like software, machinery, and equipment for workers, where technically feasible. Some argue that the likelihood of such a substitution depends critically on overall economic conditions. For instance, when aggregate demand is growing rapidly, many small firms would be likely to use the investment subsidy to expand operations, increasing the size of their workforce. But when aggregate demand is contracting, many small firms, in a bid to outlast the downturn, could use the investment subsidy as a vehicle for reducing operating costs by shedding workers without losing much market share. In any event, according to critics, the allowance has the potential to shrink the workforces of small businesses that use it.

Critics also point out that an investment subsidy may alter the composition of the small business workforce in ways that some may deem undesirable. This is because capital and skilled labor tend to be complements in the production process, whereas capital and unskilled labor tend to be substitutes.[77] In their view, a rise in investment could increase the demand for skilled workers and lower the demand for unskilled ones.

Hidden Tax on Small Business Growth

Yet another concern raised by government support for small businesses, in the minds of critics, is that the subsidies may offer a robust disincentive to grow beyond a certain size. This effect, which some refer to as the "notch problem," is a result of the design of certain forms of support, particularly small business tax preferences. In their case, the notch problem arises when the loss of a tax subsidy implicitly penalizes the firms that had benefited from it.

The Section 179 expensing allowance again can be used to illustrate this effect. Assume the maximum allowance is set at $100,000 and the phaseout threshold at $400,000. Firms that purchase and placed in service more than $400,000 in qualified assets in a tax year would be unable to claim the full allowance. This is because the amount that could be expensed is reduced dollar for dollar when a firm's total spending on the assets exceeds the phaseout threshold. So firms invest $500,000 or more in qualified assets could expense none of that amount, leaving them with the option of recovering the cost through taking the depreciation allowances permitted under current tax law.

[77] See CRS Report R41034, *Business Investment and Employment Tax Incentives to Stimulate the Economy*, by (name r edacted) and (name redacted), p. 10.

Critics maintain that such a design gave firms an incentive not to invest more than $400,000 in qualified assets. Firms that invest more than that amount face implicit tax penalties in the form of higher marginal effective tax rates that rise as the amount of investment over $400,000 grows.[78] For a small firm hoping to accelerate its growth through investment, the Section 179 allowance has the potential to dissuade it from increasing its desired capital stock beyond a level consistent with the allowance's dollar limits.[79]

A similar concern has arisen in Canada over one of its tax subsidies for small firms. A 2011 report by the C.D. Howe Institute on improving Canadian tax subsidies for business investment in research and development noted that "the preferential treatment of small firms may have the unintended consequence of encouraging young, innovative firms to stay small and not grow into larger companies."[80] The report did acknowledge that more research needed to be done to determine the extent to which the subsidies constituted a real barrier to growth among small research-intensive companies in Canada.

Conclusions

Available economic data suggest that small firms make important contributions to the performance and growth of the U.S. economy. The magnitude of the contributions depends critically on how a small firm is defined. If a small business is defined as a business with fewer than 500 full-time equivalent employees, then it can be said that small businesses account for a majority of private-sector jobs and about half of private-sector output, generate many technological innovations, and serve as agents of renewal and structural change in a variety of industries. But if the threshold were set at fewer than 100 employees, the small business shares of output and employment would be notably smaller.

The economic contributions of small businesses, however defined, explain part of the longstanding bipartisan support in Congress for government programs to assist small business.[81] Some of this support is the preferential tax treatment available to many small firms. The combined revenue loss from existing federal small business tax subsidies may top an estimated $11 billion in FY2013; by comparison, the President's budget request for the SBA in FY2013 would support about $26 billion in loans, loan guarantees, and Small Business Investment Company debentures for eligible small firms.[82] Reflecting the political clout of the small business community and widespread concern over the continued slow pace of domestic job growth, the 113th Congress may wish to consider a number of initiatives to extend or enhance these subsidies.

[78] For any investment, the cost of capital depends in part on the investor's marginal tax rate. Jane Gravelle of CRS has estimated that under a maximum expensing allowance of $100,000, the marginal effective tax rate on corporate investment in equipment is 0% on the first $100,000, 26% on amounts above $100,000 to $400,000, 43% on amounts above $400,000 to $500,000, and 26% on amounts above $500,000. The estimate assumes the inflation rate is 2% and the corporate tax rate 35%.

[79] Holtz-Eakin, "Should Small Businesses Be Tax-Favored?" p. 393.

[80] Mark Parsons, "Rewarding innovation: Improving federal tax support for business R&D in Canada," *C.D. Howe Institute Commentary*, September 2011, p. 18.

[81] Small business owners are also valued for their work as community leaders.

[82] See http://www.whitehouse.gov/omb/factsheet/supporting-small-businesses-and-creating-jobs.

Current small business tax benefits serve a variety of purposes that can be reduced to four categories: (1) improving access to equity capital, (2) simplifying tax compliance, (3) promoting capital investments, and (4) achieving other assorted policy objectives. Supporters of these benefits and other federal programs to support small business argue they are needed to remove or lessen barriers to the birth, survival, and growth for businesses that make invaluable contributions to economic growth and renewal over time. They cite the roles played by small firms in job creation and technological innovation as proof of the special importance of small businesses in general. The most likely barriers, they say, are problems in credit and equity markets that prevent too many new small firms from being formed, especially innovative ones, and hasten the demise of too many existing small businesses. Most lawmakers would appear to agree with this view.

Yet the findings of some recent studies and recent changes in federal policy toward new firm financing raise questions about this economic rationale. In particular, they suggest that current federal support for small business may be wasteful and less effective than it could be in promoting faster job growth and increased investment.in technological innovation.

A 2011 study by economists Erik Hurst and Benjamin Pugsley using a database consisting of individuals in the process of starting a business found that most small business owners are not the entrepreneurs that economic models and lawmakers tout as prolific job creators and innovators who open up new pathways for economic growth by accelerating the demise of older technologies.[83] Instead, their research showed that few small firms bring new ideas to the market, and that most are content to provide an existing service to a local established market. It also indicated that few small business owners have a strong desire to grow large and to innovate. This disposition was consistent with the main characteristics of the professions in which the majority of small businesses operated: skilled craftsmen, lawyers, real estate agents, doctors, small shop owners, and restaurateurs. Hurst and Pugsley found that for perhaps half the people starting a new business in 2004, the primary motivations were non-pecuniary, especially being one's own boss and having flexible work hours.

A 2010 study by economist John Haltiwanger and Ron Jarmin and Javier Miranda from the U.S. Census Bureau used data from the Census Bureau Business Dynamics Statistics and Longitudinal Database to test the widely held belief that job growth over time is negatively related to firm size. The results confirmed the belief when the researchers controlled for industry and year effects only. But when they also controlled for the age of firms, that relationship disappeared. What emerged instead was a systematic relationship between gross and net job creations and the age of firms. More specifically, the results showed that start-ups exhibit relatively high rates of job creation and job destruction from 1992 to 2005.

The findings from the two studies raise questions about the justification for current federal policy toward small business growth and development. Specifically, the findings leave little doubt that most job growth and a significant portion of technological innovation is likely to come from the activities of a relatively small number of new companies. Congress may wish to explore ways to modify federal support for small business so that it more effectively and efficiently targets the difficulties holding back the formation and early growth of small startup companies with a strong interest in developing new technologies and bringing them to the market. Identifying these companies is itself a significant challenge for public policy. Hurst and Pugsley suggested as one

[83] See Erik Hurst and Benjamin Wild Pugsley, *What Do Small Businesses Do?*, NBER working paper 17041 (Cambridge, MA: May 2011).

option having the SBA work with venture capitalists to find new entrepreneurial small firms that might benefit from early-stage federal financial assistance. They also contend that a better understanding of the costs and benefits of current federal support for small businesses may help lawmakers determine which current programs address the needs of those firms and which should be jettisoned as superfluous.

Most economists believe that departures from uniform or neutral taxation of the returns to capital are warranted only to correct identifiable market failures. This raises the question of whether existing federal government support for small firms is intended to remedy any market failure. One possible market failure is that too few small businesses are being formed in light of their contributions to employment growth and technological innovation and barriers in debt and equity markets to small business startup financing.

Is there evidence that too few small innovative firms are being formed? Certainly imperfections in capital markets can and do prevent some individuals from getting the funds they need to start a new business and grow it. This can happen for a variety of reasons, including asymmetric information between aspiring entrepreneurs and lenders or investors and excessive caution on the part of lenders and investors. A 2010 study by Alicia M. Robb and David T. Robinson of the financing choices of firms in their first year of business indicated that the vast share of the firms in their sample relied much more on external debt than family and friends as a source of start-up capital.[84] They found that the start-up capital for over 80% of those firms was split evenly between bank debt and owner equity. The findings suggested that well-functioning credit markets were critical to the formation and success of most new small firms.

The federal government is using several measures to improve the access to capital for new businesses, including SBA loan guarantees, tax preferences for investment in small startup firms and business startup costs, and the recent dismantling of regulatory obstacles to using a method of raising equity capital known as "crowdfunding." Under this method, aspiring small business owners can raise small amounts of money from a large pool of investors, usually through the Internet, without running afoul of federal securities laws. Congress may wish to look into the question of whether additional measures are needed to speed up the rate of new entrepreneurial business formation.

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[84] Alicia M. Robb and David T. Robinson, *The Capital Structure Decision of New Firms*, working paper 16272, National Bureau of Economic Research (Cambridge, MA: August 2010), p. 25.