TAX REFORM AND SMALL BUSINESS

Eric J. Toder *
Institute Fellow, Urban Institute and Co-Director, Urban-Brookings Tax Policy Center

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Chairman Chabot, Ranking Member Velazquez, and Members of the Committee. Thank you for inviting me to appear today to discuss the effects of tax reform on small business.

There is a growing consensus that the current system of taxing business income needs reform and bi-partisan agreement on some of the main directions of reform, although not the details. The main drivers for reform are concerns with a corporate tax system that discourages investment in the United States, encourages U.S. multinational corporations to retain profits overseas, and places some US-based multinationals at a competitive disadvantage with foreign-based companies, while at the same time raising relatively little revenue, providing selected preferences to favored assets and industries, and allowing some US multinationals to pay very low tax rates by shifting reported profits to low tax countries.

- The United States has the highest corporate tax rate in the Organization of Economic Cooperation and Development (OECD). This discourages investment in the United States by both U.S. and foreign-based multinational corporations and encourages corporations to report income in other jurisdictions.

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- The U.S. rules for taxing multinational corporations encourage U.S. firms to earn and retain profits overseas and place some companies at a competitive disadvantage, encouraging them to engage in transactions (called inversions) that shift their corporate residence overseas.
- In spite of its high corporate tax rate, the U.S. tax system generates less corporate revenue as a share of GDP than the OECD average, partly due to more generous business tax preferences in the United States than elsewhere, but also due to the relatively high share of U.S. business income that is not subject to the corporate income tax.

In response to these concerns, proposals for corporate tax reform by both former House Ways and Means Chairman Dave Camp and President Obama include the following elements:

- reduce the top federal corporate income tax rate (from 35 percent to 25 percent in the Camp proposal, and to 28 percent in President Obama's corporate reform framework);
- pay for the lower corporate income tax rate in part or in whole by eliminating or scaling back tax preferences for business income; and
- reform international taxation rules. The international tax reform proposals by Camp and Obama differ greatly in detail, but both include three major building blocks: 1) elimination of taxation of repatriated profits by U.S. multinationals, 2) a low-rate lump sum transition tax on past accrued foreign profits, payable over a number of years, and 3) going forward, a minimum or low rate tax on foreign profits in excess of a normal return on tangible assets.

While a main goal of business tax reform is to fix our broken corporate income tax, the base-broadening proposals needed to pay for a lower corporate rate will affect all businesses, whether organized as taxable corporations under sub-chapter C (C corporations) or as so called-flow through entities, such as partnerships and corporations taxed as pass-through entities under subchapter S of the Internal Revenue Code (S corporations). Most small businesses are organized as pass-through entities. These firms pay no corporate income tax, instead reporting their income annually to their partners and shareholders for inclusion in their taxable income under the individual income tax. Most sole proprietors also pay individual income tax on their business income. As a result, a combination of a lower corporate tax rate and reduced business tax preferences will raise taxes on partnerships, S corporations, and sole proprietors unless offset by other measures. Many of the companies potentially subject to higher taxes on their profits are small businesses, defined in terms of their asset size, their gross receipts, or their number of employees.

This potential for tax reform to raise taxes on flow-through businesses is a major hurdle that proponents of corporate tax reform need to confront. In this testimony, I discuss the extent of problems this may create for small businesses and comment briefly on possible ways of addressing it. I will first present some background data on the relation between tax changes on pass-throughs and small businesses and then make some comments about the implications of tax reform for small businesses. I make the following points:

- A large and growing number of U.S. businesses are organized as pass-throughs. Most pass-through entities are small companies, but much of the net income and business receipts of pass-throughs comes from large and mid-sized businesses.

- Pass-throughs are taxed more favorably than C corporations on average, even though the top individual rate is slightly higher than the top corporate rate because pass-throughs face only one level of tax on their profits, while profits earned in C corporations are taxed at both the corporate and individual levels.

- The overwhelming majority of taxpayers with business income are not in the top two tax brackets. Most business income is received by taxpayers at the highest income levels, but this income is not necessarily from "small" businesses.

- Business tax reform proposals that reduce the corporate tax rate and eliminate tax preferences would reduce the current law benefit of operating as a pass-through. Both pass-through firms and C corporations would lose some of their tax preferences, but pass-throughs would not benefit from a lower corporate tax rate. They could choose to become C corporations in response to a reduced corporate rate, but then they would face two levels of tax if they chose to pay dividends to shareholders.

- Large pass-throughs would be affected much more than small pass-throughs by the elimination of business preferences, unless Section 179 expensing was also repealed. Retention or expansion of the high limits for Section 179 expensing in effect through the end of 2014 would help all small firms, including small closely-held firms that incorporate. Closely-held corporate firms can also minimize the impact of the corporate double tax by delaying taxable dividends they pay to their owner-employees.

I discuss each of these points in turn and then make some concluding remarks about options that might make business tax reform more favorable to small businesses.

IMPORTANCE OF PASS-THROUGHS AS A FORM OF BUSINESS ORGANIZATION

The share of businesses organized as pass-throughs and their share of business profits has been growing since the early 1980s (Plesko and Toder 2013). Factors driving this growth have been the narrowing of the differential between top individual and corporate rates (70 percent compared to 46 percent in 1980; 39.6 percent compared to 35 percent today) and the large growth in opportunities for firms to organize either as sub-chapter S corporations or as limited liability partnerships and still receive the benefits of limited liability that were at one time only available to firms subject to the corporate income tax.

In 2011, pass-throughs accounted for 95 percent of all business tax returns (table 1). Large corporations continue to be dominant in many economic sectors, but pass-throughs in 2011 accounted for almost 40 percent of business receipts. And, in 2008, the last year for which published data on taxable profits were available for C corporations, pass-throughs, including sole proprietorships, accounted for over 65 percent of net business profits (Altshuler, Shay, and Toder 2015).

In 2011, by far the largest share of business returns were filed by sole proprietors, who accounted for 72 percent of returns (table 1). Sole proprietors, however, accounted for only about 4 percent of business receipts, with the remaining coming from C corporations (62 percent), S corporations (20 percent), and partnerships (14 percent).

TABLE 1. DISTRIBUTION OF RETURNS FILED AND BUSINESS RECEIPTS BY BUSINESS RETURN TYPE, 2011

	Sub-C Corporations	Partnerships	Sub-S Corporations	Sole Proprietorships	Total
Number of returns (in millions of dollars)	1.7	1.3	4.2	23.4	32.5
Business receipts (in billions of dollars)	19.1	4.5	6.1	1.3	30.9
Share of returns	5.1%	10.1%	12.8%	72.0%	100.0%
Share of business receipts	61.8%	14.4%	19.7%	4.1%	100.0%

Source: Internal Revenue Service, Statistics of Income, at http://www.irs.gov/uac/SOI-Tax-Stats-Partnership-Data-by-Size-of-Total-Assets; http://www.irs.gov/uac/SOI-Tax-Stats-Nonfarm-Sole-Proprietorship-Statistics; http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Source-Book:-U.S-Total-and-Sectors-Listing.

Although the C corporate form is still the dominant form of organization for large corporations, much of the business activity in S corporations and partnerships also comes from large and mid-sized companies, not small businesses (table 2). Among partnerships and S corporations combined, in 2012, 56 percent of returns were filed by businesses with assets of $100,000 or less, but these firms accounted for only 9 percent of business receipts and 12 percent of net profits in excess of net losses. At the other end of the spectrum, 31 percent of business receipts (35 percent of net profits) of partnerships and S corporations came from firms with $100 million or more in assets and 55 percent of receipts and net profits came from firms with $10 million or more in assets, yet they comprise only 0.3 percent (2.1 percent) of total returns.

TABLE 2. DISTRIBUTION OF PARTNERSHIP AND S CORPORATION RETURNS, BUSINESS RECEIPTS, AND NET INCOME BY ASSET SIZE (IN PERCENT)

	$100,000 or less	$100,000 to $1 million	$1 million to $10 million	$10 million to $100 million	$100 million or more
Partnerships					
Returns	46.8	28.7	20.2	3.6	0.7
Business receipts	8.1	7.2	15.3	18.3	51.0
Net business income*	8.4	7.5	10.9	18.4	54.8
S Corporations					
Returns	63.5	28.4	7.1	0.9	0.1
Business receipts	9.7	19.5	27.4	27.1	16.3
Net business income*	15.5	19.9	24.5	21.3	18.8
Partnerships plus S Corporations					
Returns	56.1	28.6	12.9	2.1	0.3
Business receipts	9.0	14.3	22.3	23.4	30.9
Net business income*	12.3	14.3	18.4	20.0	35.0

**Equals net profits for firms with positive profits minus net losses for firms with losses.*
Source: Internal Revenue Service, Statistics of Income, at http://www.irs.gov/uac/SOI-Tax-Stats-Partnership-Data-by-Size-of-Total-Assets; http://www.irs.gov/uac/SOI-Tax-Stats-Nonfarm-Sole-Proprietorship-Statistics; http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Source-Book:-U.S-Total-and-Sectors-Listing.

FAVORABLE TAX TREATMENT OF PASS THROUGHS COMPARED WITH C CORPORATIONS

Owners of pass-through businesses are taxed more favorably than owners of C corporations because they pay only the individual income tax, while the profits of C corporation shareholders are taxed at the both the corporate level and again at the individual level when paid out as dividends or realized as capital gains. For example, compare a business owner in the top income bracket receiving $1 million of net taxable profits from shares in an S corporation with a similar business owner in a C corporation with $1 million of taxable profits. The S corporation owner would report $1 million of business income and pay a tax of $396,000 at the top rate of 39.6 percent. There would be no additional tax if the S corporation distributes to her some of the profits.

The C corporation would first pay tax at a 34 percent federal rate (the rate applicable to $1 million of corporate income), leaving $660,000 to be either retained and reinvested or distributed to the shareholder in the form of a dividend or stock repurchase. If the corporation never pays a dividend and the shareholders holds the stock until death or donates the proceeds of stock sales to charity, there will be no individual income tax on the profits and the C shareholder will be slightly better off than the S corporation shareholder because the corporate rate is lower than the top individual rate. If, however, the shareholder receives personal access to the profits, either in the form of a dividend or a realization of capital gains attributable to reinvestment of the profits, then there will be a second level of tax. For a taxpayer in the top federal tax bracket for dividends and capital gains (now 23.8 percent, including the high income investment income surtax), if all after-tax profits were distributed, that second level of tax would be an additional $157,080 (23.8% of $650,000), leaving a net profit of $502,920. This would amount to a total federal tax rate of 49.7 percent on distributed profits. If only some profits are distributed, the tax rate would be somewhere between 34 percent and 49.7 percent.

The unfavorable treatment of C corporation income relative to flow-through income has two adverse consequences. First, it discourages the use of the C corporate form, which might be preferable for firms seeking to go public and gain access to wider pools of capital. Second, it tilts the playing field against activity in sectors of the economy in which publicly-traded corporations organized as C corporations are more prevalent. One of the goals of many tax reform proposals in the past has been to eliminate the bias against corporate investment by eliminating the double taxation of corporate income (see, for example, U.S. Treasury Department 1992).[1]

Other characteristics of the tax landscape also affect the relative burdens imposed on small compared with large businesses. Tax compliance places a large burden on small business per dollar of receipts or profits, reflecting economics of scale in tax compliance (Contos et al, 2012). In the other direction, however, IRS finds lower compliance rates for small businesses, especially those that can deal in cash, than for large corporations (Internal Revenue Service, 2012). Small businesses also benefit from several special provisions of the tax code, including Section 179 expensing, the use of cash accounting methods, graduated corporate tax rates, and some special preferences for capital gains on small corporate stock. These costs and benefits are discussed in more detail in Marron (2014), Gale and Brown (2013), and Toder (2007).

WHO RECEIVES INCOME FROM PASS-THROUGH BUSINESSES

I now summarize data on who receives income from pass-through businesses. For this purpose, I define “business income” as income reported on Schedule C (income from business and self-employment), Schedule E (partnership income, S corporation income, and rental and royalty income), and Schedule F (farm income) on individual income tax returns.

[1] The double taxation of corporate income has other adverse consequences including the encouragement of debt over equity finance, because interest but not dividends are deductible, and an incentive for corporations to retain and re-invest profits instead of paying out dividends or buying back shares.

For tax year 2015, the Tax Policy Center estimates that slightly fewer than 22 percent of tax units (including non-filers) will report some form of business income or loss (see table 3a). These returns include many individuals whose primary source of income is earnings or investment income (interest, capital gains, and dividends) and who may receive only a small amount of additional income from self-employment or a passive investment in real estate. Tax units who receive more than 50 percent of their income from business amount to less than 7 percent of all tax units. Overall, business income is about 9 percent of adjusted gross income (AGI).

The share of returns with business income and business income as a percentage of AGI increase as income increases. Only slightly more than 2 percent of tax returns with AGI between $30,000 and $75,000 receive more than half their AGI from business income, while 22 percent of taxpayers with AGI between $500,000 and $1 million and 32 percent of taxpayers with AGI of $1 million or over receive more than half their income from ownership of businesses. Business income as a share of AGI is less than 3 percent for taxpayers with incomes between $30,000 and $75,000 and almost 30 percent of AGI for taxpayers with income over $1 million.

Most taxpayers reporting business income have relatively modest incomes, but most business income is earned by very high-income taxpayers (table 3b). Almost 80 percent of tax units with half or more of their AGI from business have total AGI less than $75,000 (compared with 96 percent of all tax units), but almost 75 percent of business income goes to tax units with AGI over $200,000 (compared with about 35 percent of all income).

TPC TABLE 3A. CHARACTERISTICS OF BUSINESS INCOME BY INCOME GROUP, 2015

AGI group in $thousands	Share of Returns with Business Income	Share of Returns with Business Income Greater than 50% of AGI	Business income as percentage of AGI	Average AGI (dollars)	Average business income (dollars)
Less than 30	14.4%	7.3%	8.7%	10,978	955
30-75	20.1%	2.4%	2.7%	48,832	1,321
75-200	34.2%	3.7%	3.6%	115,057	4,119
200-500	53.1%	9.2%	9.7%	285,472	27,772
500-1,000	70.6%	21.8%	21.4%	686,107	146,813
1,000 and over	83.1%	32.4%	28.7%	3,174,553	911,996
All returns	21.6%	6.7%	9.0%	59,197	5,397

Source: Tax Policy Center simulations, unpublished. April 2015.

TABLE 3B. DISTRIBUTION OF RETURNS WITH BUSINESS INCOME, 2015

AGI group in $thousands	Distribution of Returns	Distribution of Returns with Business Income	Distribution of Returns with Business income greater than 50 percent of AGI	Distribution of AGI	Distribution of Business Income
Less than 30	51.1%	34.8%	67.6%	9.2%	8.4%
30-75	26.9%	25.5%	11.7%	21.5%	6.1%
75-200	18.3%	29.6%	12.2%	34.6%	12.9%
200-500	2.9%	7.3%	4.9%	13.7%	13.9%
500-1,000	0.5%	1.6%	1.9%	5.3%	11.8%
1,000 and over	0.3%	1.2%	1.8%	15.7%	47.0%

Source: Tax Policy Center simulations, unpublished. April 2015.

Tax reforms that reduce both the top individual rate and the top business tax rate would lower the tax applied to most business income, but would not benefit most of the taxpayers who receive over half their income from business sources because 92 percent of them are currently in the 25 percent bracket or less while another 5 percent face a marginal tax rate of 26 or 28 percent under either the regular income tax or the individual alternative minimum tax (table 4). In contrast, the small percentage of returns currently facing the top individual marginal income tax rate of 39.6 percent accounts for 62 percent of business income reported on individual income tax returns.

TABLE 4. DISTRIBUTION OF RETURNS WITH BUSINESS INCOME BY MARGINAL TAX RATE BRACKET, 2015

Marginal tax rate	Distribution of all returns	Distribution of returns with business income	Distribution of returns with business income greater than 50% of AGI	Distribution of AGI	Distribution of business income
25 percent or less	94.6%	87.9%	91.8%	61.2%	18.9%
26 or 28 percent*	4.6%	9.5%	4.8%	20.4%	16.1%
33 or 35 percent	0.3%	0.7%	0.8%	1.7%	3.2%
39.6 percent	0.5%	1.9%	2.6%	16.7%	61.7%

**Includes taxpayers on individual alternative minimum tax.*
Source: Tax Policy Center simulations, unpublished. April 2015.

TABLE 5. REVENUE LOSSES FROM MAJOR CORPORATE TAX EXPENDITURES THAT ARE ALSO CLAIMED BY PASS-THROUGH BUSINESSES, 2015-24 (IN BILLIONS OF DOLLARS)

Tax Expenditure Line Item	Corporate revenue loss	Individual revenue loss	Total revenue loss	Individual share of cost (%)
Accelerated depreciation of machinery and equipment	194.8	112.0	306.8	36.5%
Deduction for US production activities	140.1	38.7	178.7	21.6%
Accelerated depreciation on rental housing	5.7	26.7	32.4	82.4%
Expensing of certain small investments	0.6	6.6	7.3	91.2%
Energy production credit	12.1	6.1	18.2	33.3%
Expensing of research and experimentation expenditures	70.3	5.3	75.6	7.0%
Credit for low-income housing investments	83.6	4.4	88.0	5.0%
Expensing of certain multi-period production costs, agriculture	0.3	4.2	4.6	92.8%
Expensing of percentage over cost depletion, fuels	10.9	2.7	13.6	20.0%
Expensing of certain capital outlays, agriculture	0.2	2.4	2.6	92.8%
Expensing of multi-period timber growing costs	2.6	1.5	4.1	26.7%
Expensing of exploration and development costs, fuels	5.0	1.2	6.2	19.8%
Tax incentives for preservation of historic structures	5.6	1.0	6.5	14.5%
Other corporate tax expenditures	35.3	4.8	40.1	11.9%

Source: Office of Management and Budget, Budget of the United States Government 2016, Analytical Perspectives, Tables 14-2A and 14-2B, and authors' calculations.

HOW PASS-THROUGHS WOULD BE AFFECTED BY ELIMINATION OF CORPORATE TAX PREFERENCES

Tax preferences for businesses take the forms of special tax deductions, tax credits, and acceleration of capital cost recovery allowances. Some of the largest tax preferences for corporations also reduce taxes paid by pass-through businesses. The corporate tax preferences that benefit pass-through businesses the most, measured by their projected revenue costs in fiscal years 2015-2024, are accelerated depreciation of machinery and equipment ($112 billion), the deduction for US production activities ($39 billion), and accelerated depreciation on rental housing ($27 billion). Note that these estimates published in the FY 2016 budget assume that business tax benefits that expired at the end of 2014 will not be extended. Therefore, they do not include the effects of bonus depreciation for investment in machinery and equipment and the temporarily higher limits for expensing of qualified assets under Section 179 of the Internal Revenue Code for investments undertaken after January 1, 2015.

The 10-year revenue gain between fiscal years 2015 and 2024 from eliminating provisions that accelerate the timing of deductions, such as accelerated capital cost recovery provisions and expensing of certain small investments (section 179) is larger than the 10-year tax expenditure for two reasons. First, in the tax expenditure estimates, the revenue loss from accelerating new deductions is offset by a revenue gain in the budget period from past investments that have already used up their depreciation allowances. The revenue effect from a change in the law, however, would only apply to new investments. Second, this offset to the revenue loss from prior year investments is larger than it otherwise would be in the tax expenditure estimates because of temporary provisions such as bonus depreciation and the higher Section 179 expensing limits that further shifted cost recovery deductions on existing capital assets to earlier years.[2]

These figures do not include the effects of changes in inventory accounting rules, which are counted as tax expenditures by the Joint Committee on Taxation but not the Treasury Department. Changes in inventory accounting rules could be designed in ways that do not affect small businesses that use a cash basis of accounting. The tax expenditure estimates also do not reveal other options for raising taxes on business income through changes in provisions that are not explicitly listed as tax expenditures. Two of these options are proposals that would limit corporate interest deductions and tax certain large pass-through businesses as corporations. The first of these options would not affect pass-through businesses because current law does not favor debt over equity for pass-through entities. The second option could substantially raise taxes on large pass-throughs, including publicly-traded pass-throughs such as real estate investment trusts (REITs). That option would, however, exclude small businesses and may also exclude privately-held companies if limited to publicly-traded pass-throughs.

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[2]For the same reason, however, the 10-year revenue gain from provisions that eliminate accelerated deductions overstates the long-run revenue gain from these provisions because the lower cost recovery deductions on investments made in the budget period will be offset by higher deductions on these investments outside the budget window. With investment growing, there is still a permanent revenue gain from delaying cost recovery deductions on new investments, but the long-run gain is less than the short-run gain.

WHAT OTHER MEASURES MIGHT OFFSET THE LOSS OF TAX PREFERENCES FOR SMALL BUSINESSES

The problem corporate tax reform would pose for pass-through businesses and for the subset of these businesses that are genuinely small business occurs because lowering only the corporate tax rate compensates corporations on average for base-broadening, but does not provide any direct benefit for pass-through businesses.

This problem can be mitigated if the approach to tax reform is broader, as in the Tax Reform Act of 1986, which reduced marginal tax rates for both individuals and corporations in exchange for reduction and elimination of both individual and corporate tax preferences. That approach was the announced framework of Representative Dave Camp's plan, which sought to reduce both the top corporate and individual tax rates to 25 percent while maintaining revenue neutrality and keeping the distribution of tax burdens roughly unchanged.

As finally drafted, Representative Camp's plan did achieve its stated objectives of maintaining current law revenues and the distribution of tax burdens by income group, according to scoring by the Joint Tax Committee. Difficult choices had to be made to meet these goals, however (see Nunns, Eng, and Austin 2014). The headline top individual rate of 25 percent was achieved only by adding on top of it a surtax rate of 10 percent at the highest incomes, making the top individual rate effectively 35 percent on an additional dollar of earnings or business income. The surtax applied to adjusted gross income instead of taxable income, and therefore did not allow taxpayers to claim itemized deductions for charitable contributions and mortgage interest in computing the surtax.[3] (The deductions for state and local income and property taxes were eliminated entirely.) So in effect the revenue and distributional targets were achieved by keeping a 35 percent top rate on individual income and scaling back or eliminating many popular deductions.

Congressman Camp and his staff deserve tremendous credit for producing a detailed reform plan that met his announced revenue and distributional targets and lowered the top individual and corporate rates. But his effort illustrated the challenges facing a broad-based tax reform plan that would maintain revenues and not shift the tax burden to lower and middle-income taxpayers. Such a plan would inevitably involve eliminating or scaling back many popular and widely-used tax benefits that members of both parties are reluctant to challenge. And even so, it still may be not be possible to reduce the effective top individual income tax rate very much.

In the absence of broader tax reform, however, there are several measures that can be taken to reduce the adverse effects of base-broadening on small businesses organized as pass-through enterprises. One measure would to be to extend or possibly broaden the limits for expensing assets under Section 179 of the Internal Revenue Code. Beginning on January1, 2015, taxpayers may expense

[3] President Obama's FY 2016 budget includes a similar proposal to limit the value of tax preferences of high-income taxpayers. The President would limit the tax saving from itemized deductions and some other preferences to 28 percent of the amount of the deduction or exemption.

up to $25,000 per year of investments in qualifying property, generally tangible depreciable personal property (machinery and equipment) used in the active conduct of a trade of business. The amount qualifying investment is reduced dollar for dollar for annual qualifying investment in excess of $200,000.

Before their expiration at the end of 2013 and their subsequent retroactive extension through the end of 2014, temporarily higher Section 179 expensing limits were in effect. For tax years 2010 through 2014, taxpayers were able to expense up to $500,000 in qualifying investments per year, with the phase-out of expensing beginning for dollars of investment in excess of $2 million. Restoring the higher expensing limits, or possibly raising them further, would reduce the cost of capital for small business taxpayers and substantially reduce compliance costs by eliminating the need to keep track of the cost basis of these investments. It would also protect them from the effects of any general reduction in accelerated depreciation for machinery and equipment—the largest current business tax preference for pass-throughs—because their purchases of these assets would be expensed and not affected by broader changes in depreciation rules. This tax benefit is targeted to small business taxpayers.

Another option to shield small businesses from the effect of corporate tax reform would be to accompany corporate base broadening by expanding the thresholds for the lower tax rates now available for small corporations (Kleinbard 2015). Corporations currently face lower tax rates on their first $100,000 of income; the tax rate is 15 percent on the first $50,000 of income, 25 percent on income between $50,000 and $75,000, and 34 percent on incomes between $75,000 and $100,000.[4] If the width of the 15 percent bracket were increased, small business taxpayers could benefit from tax reform by electing to be taxed as C corporations. They would still face the double taxation of corporate income, but the combination of a 15 percent rate at the corporate level and a 23.8 percent rate on dividends and capital gains (effectively a rate of slightly over 35 percent on distributed income and a 15 percent rate on retained profits) could compensate them for the loss of business tax preferences. Although conceptually flawed from a tax policy point of view because ability to pay is based on total *individual* income, not on income of corporations that individuals own, expanded the 15 percent corporate bracket would be a way of providing small businesses with targeted compensation for the effects of broadening the income tax base.

A final option that has been mentioned is to provide a special reduced tax rate for pass-through businesses. This proposal would be very problematic for several reasons. First, it would be unfair because it would provide a very large income tax rate cut to many high-income individuals who receive income from business investments, while retaining higher marginal tax rates on individuals whose income comes from labor compensation. Second, it would create many market distortions, as businesses seek ways to compensate highly paid employees by using them as independent contractors

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[4] The benefit of the 15 and 25 percent brackets is phased out at incomes between $100,000 and $335,000, raising the average rate at $335,000 to 34 percent. The 35 percent bracket begins at incomes of $10 million or higher and the benefit of the 34 percent rate is phased out between incomes of $15 million and $18.33 million.

(subject to the reduced rate on business income) instead of employees and engage in other transactions to re-characterize income (Plesko and Henry 2012). At the same time, small business owners with lower marginal tax rates, who comprise most small business owners, would not benefit.

CONCLUSIONS

Our increasingly dysfunctional corporate tax system has led to bipartisan calls for corporate tax reform. It is important, however to distinguish changes which affect only taxable *corporations* from those that affect all businesses. as it is impossible to reform the corporate income tax without also affecting owners of pass-through businesses whose business income is taxable under the individual income tax. Some, but not all of these affected taxpayers, are owners of small businesses.

The main way that tax reform could adversely affect owners of pass-through businesses is by reducing the benefits they receive from the generous capital cost recovery provisions in the federal income tax. Small businesses can be mostly protected from the effects of these proposals by targeted small business benefits, such as extending, expanding, or making permanent the tax year 2014 for limits of expensing under Section 179 of the Internal Revenue Code and by widening the 15 percent corporate rate bracket.

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