Why Small Business Should Not Get a Veto Over Corporate Tax Reform

BY JOSEPH V. KENNEDY | NOVEMBER 2016

Corporate tax reform, especially reducing the effective tax rates on investment and research and addressing taxation of foreign-source income, is too important to the nation's economy to be held hostage by any one special interest group.

Over the last several years, a great deal of effort has gone into trying to update the nation's corporate tax laws for the 21st century. Unfortunately, the small-business lobby has actively opposed these efforts, arguing that current proposals would unduly hurt its interests. Given the difficulty of passing any major policy reform, this opposition could be enough to defeat any legislation. Small-business concerns about corporate tax reform are misplaced largely because, as a group, small businesses are already taxed at a significantly lower rate than larger corporations. Corporate tax reform, especially reducing the effective tax rates on investment and research and addressing taxation of foreign-source income, is too important to the nation's economy to be held hostage by any one special interest group.

It has been 30 years since the Tax Reform Act of 1986, the last major overhaul of individual and corporate tax rates. Since then, the world has changed a great deal, but tax law has not kept up. Although both individual and corporate taxes need reform, Congress and the administration are rightly focusing largely on corporate tax reform right now.

The focus on corporate reform is due to several factors. Less agreement on individual tax policy exists between Democrats (who think that marginal tax rates on the rich should increase and that tax reform should raise total revenue in order to pay for more spending) and Republicans (who are more concerned about the incentive effect of high tax rates and have pledged not to raise taxes). Moreover, large individual tax expenditures, such as the exclusion of employer-paid health care, and deductions for mortgage-interest payments and state and local taxes are extremely popular, even though they are highly regressive and encourage unproductive behavior. Finally, almost everyone agrees that corporate reform is more urgent.

The high statutory tax rate and its application to all worldwide income are leading to a number of troublesome trends.[1] One is that the high tax rate reduces the incentive for U.S.- and foreign-owned corporations to invest in the U.S. economy. Another is that U.S. corporations face a higher effective tax rate than their foreign competitors when they vie for foreign markets. This competitive pressure has led a number of American firms either to move their headquarters abroad or to agree to be purchased by overseas companies.[2] Finally, a number of countries have recently taken actions to claim a larger share of the U.S. corporate tax base, either by claiming that multinationals unfairly minimize the amount of profits earned in their jurisdictions, or by levying a higher tax rate on the profits they do declare.[3]

Unfortunately, the momentum for reducing the corporate tax rate has been stalled for several years by strong opposition from interest groups representing small businesses.[4] For instance, an Issue Brief by the National Small Business Association opposes corporate-only reform as being unfair to the majority of its members.[5] When congressional Republicans and President Obama tried to negotiate corporate tax reform in 2015, a top official at Associated Builders and Contractors stated: "Given the option, this or nothing, nothing is better for our members."[6]

The vast majority of small businesses are not subject to the corporate income tax. Instead, these businesses are structured as sole proprietorships, partnerships, or S corporations. Their income automatically passes through the business and appears on the owners' individual tax returns, whether or not there has been any dividend or sale of ownership. The number of these entities has grown substantially over the past several decades. In 2011, these three forms of businesses accounted for almost 95 percent of business returns and 28 percent of business revenues.[7]

To be sure, a lower corporate tax rate will not directly benefit pass-throughs. This will harm the relative competitiveness of smaller firms (although as we explain below, they will still likely face a much lower tax burden than corporate shareholders do). Moreover, to the extent that a lower corporate rate is paid for by eliminating business exemptions or deductions that smaller companies use, these companies could actually see their effective rates increase (although as we will also see, it is very possible that most of the provisions eliminated will be ones that pass-throughs seldom use).

These concerns should not be allowed to hold up corporate tax reform and its key component: a reduction in the statutory and effective corporate rates, especially on companies that compete internationally and on activities such as research and development, which deliver broad economic benefits. The arguments that small business advocates put forward for why corporate-only reform is unfair to them and economically harmful are largely false and should be ignored by Congress.

CORPORATE TAX REFORM IS TOO IMPORTANT TO BE HELD HOSTAGE

Broad reform of the corporate income tax code is one of the most important steps Congress could take in order to boost productivity, create more high-paying jobs, and increase economic growth. Although some still doubt the relationship between lower corporate tax rates and investment, the economic evidence is pretty clear that the right kind of reform would deliver broad benefits. In 2014, then-chairman of the House Committee on Ways and Means Dave Camp issued a comprehensive reform proposal of both individual and corporate taxes. The Joint Committee on Taxation, which is normally conservative on dynamic scoring, estimated that the legislation would increase GDP by between 0.1 and 1.6 percent over the next 10 years, bringing in an additional $50 billion to $700 billion in revenues.[8]

Pass-throughs will still have an advantage because they only have to pay one level of tax, whereas corporate shareholders have to pay two.

Since the last comprehensive reform in 1986, the United States has moved from having one of the lowest statutory corporate tax rates to having the highest among OECD members. And despite claims to the contrary, this translates into high effective rates, placing U.S. corporations at a competitive disadvantage when they compete in foreign markets. It also strongly discourages foreign investment or relocation to the United States. In fact, over the last few years, a growing number of U.S. companies have sought to change their nationality, either by inversions or direct acquisitions.[9] Meanwhile, foreign countries compete aggressively to attract U.S. investment. The combination of the ability to defer U.S. tax and large amounts of unrepatriated cash is also becoming an attractive target for foreign countries that want to increase tax revenues without incurring domestic opposition.[10]

Ample evidence indicates that corporate taxes impose an especially large deadweight burden on the economy.[11] Individual income taxes and consumption taxes, such as value-added taxes distort incentives less. All things being equal, switching tax revenues from the corporate to the individual side should boost the economy. Given the importance of lowering the corporate rate as far as possible and the political need to deal with the budget deficit through both individual tax increases and entitlement cuts, little room exists for cutting individual rates without also addressing the most important tax expenditures, especially on the individual side. However, it would be unwise to hold up corporate reform until this happens, as it may be a long time before the political will emerges to make these tough decisions.

PASS-THROUGHS PAY A LOWER OVERALL EFFECTIVE TAX RATE

Small-business defenders anchor their opposition to corporate-only tax reform on a fairness argument, rightly claiming that corporate tax rate cuts will reduce the differential between what C corporations and pass-throughs pay. But even if tax reform results in a statutory corporate rate that is far below the individual rate, pass-throughs will still have an advantage because they only have to pay one level of tax, whereas corporate shareholders have to pay two.

Owners of pass-through businesses see their business income show up right away on their individual returns. If they are in the highest bracket, they currently pay 39.6 percent of each additional dollar in income. A C corporation currently pays 35 percent of its income in tax. However, if its shareholders want to enjoy some of this profit, either through dividends or by selling the appreciated stock, they must pay an additional 23.8 percent in capital-gains tax, resulting in a total tax of almost 50 percent. Thus, the pass-through enjoys a marginal rate advantage of about 10 percentage points. Moreover, most taxpayers with business income are not in the top two individual income tax brackets.[12] Even if the corporate rate were reduced to 25 percent, these individuals would still have a lower effective personal rate.

As a last resort, pass-throughs can convert their status to a C corporation if they really believe that doing so lowers their taxes. Some people have expressed the concern that making the corporate rate much lower than the individual rate will cause businesses to do exactly this, in an attempt to avoid individual taxes, and that this would distort economic activity. It is not clear that this will happen, especially if the top individual tax rates remain below 50 percent. The danger can also be mitigated by regulations that restrict large capital accumulations in the company and by eliminating the step up in basis that allows new owners to avoid individual tax on the past increase in value of inherited property. Thus, any distortionary effects should be minimal.

Jane Gravelle summarizes many of the specific tax provisions that benefitted small business in 2008. In addition to Section 179, which lets small businesses immediately expense a large amount of investment each year but phases out as the amount of investment grows, a number of other tax provisions are specifically directed at small business. These include the lower statutory corporate tax rates for those small businesses that choose to organize as C corporations, the enhanced deductibility of personal business expenditures, including health-care costs, and exemptions from the alternative minimum tax.[13] She estimates that collectively these amount to tax savings of almost $100 billion per year compared with what these firms would pay if they were larger C corporations. Gravelle concludes that, although the tax differential has narrowed over time, "in general small business appears to be favored."[14]

In a recent paper, Eric Toder agrees, noting, "For businesses that are equivalent in other respects, noncorporate enterprises are taxed more favorably than C corporations."[15] Moreover, partly because they are based more on cash and check transfers and are seldom audited, pass-throughs have a much higher rate of tax avoidance. Summarizing an IRS study, Toder reports net misreporting percentages of 57 percent for nonfarm sole proprietorships, 29 percent for small corporations, 18 percent for partnerships and S corporations, and just 14 percent for large corporations.[16]

REDUCING CORPORATE TAX EXPENDITURES WILL HAVE A SMALL EFFECT ON SMALL BUSINESSES

Many pass-throughs use business deductions, exclusions, and tax credits to reduce their tax liability. Eliminating these provisions will result in higher total taxes for pass-throughs. Yet the total effect of these reductions is likely to be small.

First, most tax expenditures are for individuals, not businesses. According to the most recent president's budget, total corporate-tax expenditures over the next 10 years are expected to cost just under $2 trillion. Individual tax expenditures will exceed $15 trillion over that same time period.[17]

Second, the most important business provisions are likely to be kept because they deliver broad economic benefits. In testimony before the House of Representatives Small Business Committee, Eric Toder itemized the main corporate tax expenditures that are also claimed by pass-through entities.[18] Updating his table to reflect the current year budget, the 13 largest corporate tax expenditures are expected to benefit pass-through entities by $254.6 billion over the next decade. The largest two items on this list are the accelerated depreciation for machinery and equipment and the deduction for U.S. production activities. These account for 68.9 percent of all tax benefits to pass-throughs. But neither of these provisions is likely to be changed as a result of any reform. Accelerated depreciation lowers the after-tax cost of investment, which is closely linked to productivity. The deduction for domestic production is widely supported in Congress for keeping manufacturing in the United States. Only the third item, accelerated depreciation on rental housing ($43.1 billion), comes close in size to these two provisions. Yet, given the strong support tax law already provides to real estate, the public-policy argument for keeping this provision is weak. Not all provisions that help small businesses are good policy. Where they are not, reform should eliminate them in order to lower the statutory rate. All other provisions used by pass-throughs are relatively small.

It is very unlikely that Congress would reduce Section 179's benefit. In fact, lawmakers could and should expand it by eliminating the investment ceiling.

The picture is not much different when we look at small businesses (as opposed to pass-throughs). A paper commissioned by the Small Business Administration used 2013 data to estimate that small businesses enjoyed 25 percent of the benefits from major corporate tax expenditures.[19] Considering only the expenditures that were worth over $5 billion annually, only accelerated depreciation on rental properties is likely to be cut in any reform. In this list, 40 percent of tax benefits actually came from the ability to deduct retirement and health-care premiums from individual income.

Finally, small businesses specifically benefit from the ability to immediately expense investments in qualifying property under Section 179 of the Tax Code. This provision allows companies to expense up to $500,000 in investments each year. The benefits are clawed back starting when annual investment exceeds $2 million, so that larger companies do not receive any benefit. It is very unlikely that Congress would reduce Section 179's benefit. In fact, lawmakers could and should expand it by eliminating the investment ceiling.

MOST PASS-THROUGH INCOME IS EARNED BY LARGE BUSINESSES

Unfortunately, the emotional support for small businesses tends to get conflated with the tax treatment of pass-through entities. Yet pass-through income is largely skewed toward big businesses.[20] Although businesses making $100,000 or less filed 56.1 percent of partnership and S-corporation returns in 2012, they earned only 12.3 percent of net business income. Most net business income (55 percent) was earned by entities with $10 million or more in assets, even though they filed only 2.4 percent of the returns. Companies with at least $100 million in assets accounted for 35 percent of net business income. The truly small businesses that Congress is concerned about make up only a small minority of the economic activity that would be affected by corporate tax reform. Most of the activity occurs in large firms that are fully capable of responding to changes in tax law, including shifting over to become C corporations if it becomes economical to do so.

TAX LAW SHOULD NOT FAVOR PASS-THROUGH ENTITIES

Neither is there a clear reason why tax law, nor any other policy, should favor smaller businesses.

Most economists believe that tax law should try not to influence major corporate decisions such as whether to raise funds through debt or equity, whether to realize profits now or later, and what organizational form to take. They make exceptions for a few activities, such as research and investment, which deliver broad social benefits in excess of what firms accrue alone. There is no clear reason why tax law should encourage businesses to organize as partnerships or S corporations rather than as C corporations.

Neither is there a clear reason why tax law, nor any other policy, should favor smaller businesses. Unlike most large multinational corporations, most small companies do not directly compete with foreign companies, either here at home or in overseas markets. Therefore, the effect of higher rates on small companies is limited, since they don't compete with firms overseas facing lower rates. Where they do compete, they will still be able to take advantage of special provisions that encourage productive activity, such as the research and development tax credit and any potential innovation box. Instead, most small businesses compete against entities like themselves in local markets, so any higher taxes are borne by all competitors and do not benefit one firm over others.

The economic superiority of small business over large is also illusory. Compared with larger businesses, as a class, small companies have lower levels of productivity, pay lower wages, export less, invest less in research and development, have poorer safety records, and lay off their workers more frequently.[21] Moreover, the notion that small business is the source of jobs is also a myth. From 1993 to 2010, small firms with 1 to 19 employees were responsible for 29 percent of gross job creation in the United States, but only 15 percent of net job gains. In other words, they created lots of jobs, but because they go out of business at such high rates, they also destroyed lots of jobs. In contrast, firms with over 500 employees were responsible for 26 percent of gross job gains, but 38 percent of net job gains.[22] Gravelle reviews many of the traditional arguments for favoring small businesses, including that they create most jobs, are important sources of innovation and technology, are riskier, and have more difficulty raising capital. She concludes that these are relatively weak justifications for favorable tax treatment to small businesses.[23] Favoring small business through the tax code, as we currently do, leads to less growth and innovation, not more.

PASS-THROUGHS WILL BENEFIT FROM CORPORATE TAX REDUCTION

As explained above, sensible corporate tax reform that lowers the effective tax rate for corporations and rewards investment and innovation will boost economic growth and increase our national competitiveness. Many pass-throughs are part of multinational supply chains and rise or fall on the health of their globally traded corporate customers. Many other pass-throughs provide locally consumed goods and services (e.g., restaurants, dry cleaners, car dealers) and again will rise and fall depending on the health of larger corporations, which employ more than half of the American workforce. As corporate-tax reduction enables corporations to invest more at home and sell more abroad, pass-throughs should benefit from the extra business, both from their corporate customers and from their workers, who will have more money to spend.

CONGRESS HAS OTHER WAYS OF HELPING SMALL BUSINESS

Support for truly small businesses (as opposed to pass-through entities, which may be either big or small) is rooted in the belief that Main Street plays an important role in American culture. The strong propensity of Americans to start their own businesses creates a culture of entrepreneurship, financial independence, and social mobility that strengthens the country. However, there are other ways Congress can assist these businesses. These include tax simplification and regulatory reform.

CONCLUSION

Corporate tax reform is one of the most important initiatives before Congress. Reducing effective tax rates, especially on investment, research, and innovation—and especially for those companies that compete in international markets—is crucial for American competitiveness. Any reform should include lower statutory rates; greater incentives for investment, research, and innovation; and movement toward a territorial system. The result will be greater investment by both domestic and foreign firms, enhanced competitiveness, and faster productivity growth, which will help firms of all sizes and corporate forms.

Support for reform should not be held up by false concerns about the relative impact on pass-through entities. Tax law has long favored pass-throughs, even though by doing so it has lowered growth by taxing less productive enterprises less than more productive ones. Tax reform will be a difficult political job under any circumstances; let's not make it tougher than it needs to be.

ENDNOTES

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