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# HOW WOULD SMALL BUSINESS OWNERS FARE UNDER A BUSINESS ENTITY TAX?

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*Due to data constraints and the lack of explicit definitions, prior analyses of the impact of the tax code on small business owners were flawed. In this paper, we employ a new data source that allows a much more nuanced definition of small business owner. We present tabulations that quantify various tax characteristics of small business owners for tax year 2007. We then use our results to consider how small business owners might fare under a specific business reform proposal that levies a flat rate on all business income regardless of organizational form.*

*Keywords: business taxation, small business, flow-through income*

*JEL Codes: H20, H25*

## I. INTRODUCTION

Policymakers often express concern about the impact of the tax code on "small businesses" and "small business owners." These concerns are magnified when policymakers consider changes to the tax code that might adversely impact small business owners. For example, small business advocates have noted the detrimental impact on small business owners from allowing the top two individual income tax rates to revert to their former levels of 36 percent and 39.6 percent, as scheduled for tax year 2012 under current law. These advocates show particular interest when policymakers discuss major tax reforms, such as the changes proposed by the President's 2005 Advisory Panel on Federal Tax Reform and the 2010 National Commission on Fiscal Responsibility and Reform.

In this paper, we discuss the potential impact on small business owners of switching from pass-through taxation to a system that levies a single business tax at the entity level. To conduct this analysis, we present a new methodology to identify small businesses and their owners. Previous studies that examined the impact of the tax code on

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small business owners were unable to link the individual income tax return of certain owners to the tax return of their business entity. Hence, analysts were forced to use as a proxy for small business owners any individual who reported flow-through income from a sole proprietorship, partnership, S corporation, farming operation, or rental activity. Recently, the Joint Committee on Taxation (JCT) (2010) and the Tax Policy Center (TPC) (2010) used this approach to analyze the impact on small business owners from allowing the top two individual rates to revert to 36 percent and 39.6 percent in 2011.[1] [2]

Although small business owners comprise a large portion of the individuals who report flow-through income, the previous approach is flawed because it is both too narrow and too broad. The approach is too narrow because it excludes owners of small C corporations. It is too broad because it includes owners of large firms (e.g., partners of large hedge funds) and others who might not be engaged in canonical business activities. For example, misclassified employees and all independent contractors who file a Form 1040 Schedule C (sole proprietorship) would be counted as small business owners. In this paper, we develop an alternative approach that addresses most of these known shortcomings.

The remainder of this paper contains four sections. In Section II, we develop and apply criteria to separate business from non-business entities. We also develop criteria to further separate small businesses from other (i.e., non-small) businesses. In Section III, we use newly accessible tax return data to link individual income tax returns to their respective business entities. These new data allow us to identify pass-through income reported on the individual income tax return that is attributable to entities that meet our definition of small business. In Section IV, we examine how small business owners might fare under a system that levies a flat tax on income reported by business entities, regardless of organizational form. Such a system was a key component of the Comprehensive Business Income Tax (CBIT) advanced by Treasury (U.S. Department of Treasury, 1992) and the 2005 Tax Panel's Growth and Investment Tax (GIT) (President's Advisory Panel on Federal Tax Reform, 2005). In Section V, we summarize our results.

We note that the revised methodology discussed in this paper is but one approach that could be used to identify small businesses and their owners, and that any such attempt necessarily involves subjective judgments. However, we believe that our revised methodology allows a more nuanced analysis regarding the impact of changes to tax policy on small business owners than do previous studies.

## II. DEFINING SMALL BUSINESS

This section develops an approach to identify small businesses. The methodology proceeds in two basic steps. First, we consider what constitutes a "business entity," identifying the forms and schedules filed by individuals or firms that could potentially

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[1] The JCT measure of business income includes royalties, trusts and estates, and real estate mortgage investment conduits.

[2] The TPC analysis includes non-filers and returns with zero taxable income. Business income is defined as filers who report income or loss on Schedules C, E, or F (TPC, 2010).

represent business activity and separating those returns into business and non-business groups. Next, we further sub-divide our business group into small and other (i.e., non-small) businesses.

### A. Separating Business from Non-Business Tax Entities

There are six forms and schedules that taxpayers can file that potentially reflect business activity: Form 1040 Schedule C (sole proprietorship); Schedule E-Part I (miscellaneous rental and real estate); Schedule F (farmers); Form 1065 (partnership); Form 1120 (C corporation); and Form 1120S (S corporation). Although we refer to these forms and schedules as "business" returns, a closer inspection reveals that many filers are not engaged in business activity as it is traditionally understood. Some examples include the following:

- Many Schedule C filers work for one or more firms and receive 1099-MISC forms that report their "non-employee compensation" rather than W-2s that report wages. These filers report this compensation as gross receipts (per the instructions) and often report no deductions, or very minimal deductions, which reflect elements of personal and business use, such as transportation, travel, or meal expenses. Some of these filers are technically misclassified employees; others are correctly treated as independent contractors. In many instances, they are not substantially different than employees of the firm to whom they provide labor services.
- Individuals or entities might form partnerships to re-distribute earnings passed through from other partnerships. These entities are conduits that merely redistribute funds. Other partnerships might only hold financial assets and receive interest, dividends, or capital gains but conduct no business activity. These partnerships could be considered "passive investment vehicles."
- Certain C corporations could also be viewed as investment vehicles if they merely hold investments and conduct little or no business activity.
- Certain individuals who file Form 1040 Schedule E, Part I might report minimal income due to the incidental rental of a vacation home.
- Individuals might attempt to claim a tax loss for activity that is properly characterized as a hobby, not a business.

The first step in our revised methodology is the development of criteria to separate business from non-business entities. To do this, we look to the tax code. Despite the stylized examples above, the distinction between business and non-business activity is not always clear, and the Internal Revenue Code (IRC) fails to provide explicit guidance because it does not define the term "trade or business." In general, the IRC characterizes most activities carried on for a livelihood or for profit as a trade or business. If it is determined that a taxpayer is engaged in a trade or business, then the taxpayer may deduct from gross income all "ordinary and necessary" expenses of carrying on the trade

or business that are paid or incurred during the tax year.[3] If there is uncertainty about whether an activity qualifies as a trade or business, then the tax authorities will apply certain tests and consider the relevant facts and circumstances of individual taxpayers. This approach is referred to as applying the "hobby loss rules." If an activity is deemed a hobby, and not a trade or business, then expense deductions are limited to the income produced by the activity so that hobby losses cannot offset other income. By contrast, there are no restrictions on active trade or business losses; they may be used to offset all other types of income, regardless of its source.

In order to distinguish hobby from business activities, the tax authorities first rely on the historical profits test from IRC Section 183(d). This test states that, in general, an activity is presumed to be engaged in for profit if the gross income from the activity exceeds the deductions attributable to the activity in any three of five consecutive tax years, including the current tax year. If an activity fails the historical profits test or the test is not applicable, then Section 1.183-2 of the Income Tax Regulations lists nine specific factors that may be used to distinguish business from hobby activity. They are as follows:

- The manner in which the taxpayer carries on the activity. Is it a "businesslike" manner?
- The expertise of the taxpayer.
- The time and effort expended by the taxpayer: Was it "substantial"?
- An expectation that assets used in the activity may appreciate in value.
- The success of the taxpayer in carrying on other similar or dissimilar activities.
- The taxpayer's history of income or losses with respect to the activity.
- The amount of occasional profits, if any, which are earned.
- The financial status of the taxpayer: Does the taxpayer have other sources of income?
- Elements of personal pleasure or recreation.

For our purposes, we condense these nine factors into two general principles that we use to determine whether activity reported on business tax returns reflects "substantial" operations that are carried out in a "businesslike" manner. They are as follows:

- *De Minimis Activity.* Does the activity generate, or have the potential to generate, income that is non-negligible to the business owner(s)? Under this principle, very small entities would not qualify as a business, even though they report income and deductions on the business return. For example, an individual who reports small amounts of rental income and expense on Schedule E from a two-month rental of a vacation home might not qualify as a business.

[3] An expense is "necessary" if it is appropriate and helpful to the taxpayer's business. An expense is "ordinary" if it is one that is common and accepted in the particular business activity.

- *Businesslike Activity.* If the income is non-negligible, do the owners undertake actions that demonstrate "businesslike" activity? If they do, then they should report expenses related to employees, inventories, investment, office supplies, utilities, insurance, or rent. Under this principle, Form 1040 Schedule C filers who report only their own labor compensation as gross receipts (e.g., certain service providers), but little or no expenses, would not qualify as a business entity because most of those filers are not substantially different from employees who earn and report wage income. Partnerships and corporations that merely redistribute income or function as investment vehicles would also not qualify as a business entity.

We convert these principles into two tests that we apply to all potential business returns. If an entity passes both tests, then we deem the entity a business. The first is the *De Minimis Test*, which requires that total income or total deductions exceed $10,000, or their sum exceeds $15,000. Receiving income and incurring expenses can signal business activity. We apply our first test to income and deductions (or their sum) reported on the tax return to allow symmetric treatment of business activity.[4] We eliminate entities that fail this test on the grounds that the reported activity, regardless of its form or nature, does not generate substantial income to the owner(s) and it is unlikely that the activity required significant time and effort on the part of the owner(s). This test also eliminates many filers who are likely engaged in hobby activities.

The second test is the *Business Activity Test*, which requires that total deductions exceed $5,000. This test eliminates entities that report only income, with minimal or no deductions, such as pure labor providers or investment vehicles. The deduction floor we impose ensures that entities deemed a business operate in a "businesslike" manner through minimal outlays for investment (depreciation expenses), the carrying of inventories (cost of goods sold), employment of individuals, rents for buildings or equipment, or payments to other firms for goods or services. More broadly, the deduction floor generally requires that business income reflect more than a pure return to labor services provided by the filer(s). This requirement appears to reflect the intention of policymakers. When tax code provisions provide preferential treatment to small businesses, the provisions usually target business expenses such as investment (e.g., Section 179 expensing), cost of goods sold (e.g., exceptions to inventory accounting), and start-up costs. Preferential treatment is not provided to individuals who merely provide labor services. Those individuals generally do not benefit from provisions targeted to small businesses in the tax code.

[4] We define total income as the sum of all income reported on the business return including gross receipts, rents, dividends, capital gains, royalties, and interest. For partnerships and S corporations, we include any gross rents reported on Form 8825, which partnerships and S corporations engaged primarily in rental activity must file. We also include all other income and deduction items reported by those entities on Schedule K. For partnerships, we exclude any ordinary income received from another partnership, estate, or trust to eliminate double counting.

We define total deductions as the sum of wages/salaries, interest paid, payments for goods and services purchased from other firms, rents, repairs, taxes, advertising, bad debts, depletion, depreciation, and other miscellaneous deductions reported by the entity. For corporations, we do not include payments for "compensation of officers" because it is likely that those deductions represent the "reasonable compensation" that owners are required to pay themselves for labor services provided to the firm.[5] By excluding those deductions, we place corporations on equal footing with partnerships and sole proprietors. General partners and sole proprietors do not report payments to themselves for services provided to the firm as a wage expense. All returns to owners' labor and capital are included in residual profits and subject to self-employment taxes. Therefore, we must observe deductions other than wage payments to corporate owners to consider an entity a business.

We make one further adjustment to this test: we check if the sum of gross receipts and rents comprises less than 10 percent of total income. In those cases, the entity essentially reports investment income only. To ensure that those entities are not merely passive investment vehicles, we exclude interest expense from total deductions. Our tests would deem an entity that reports $50,000 of interest income and $20,000 of interest expense as a "non-business." For entities that primarily report investment income, we must observe deductions other than interest expense to deem the entity a business.

## B. Results: Business vs. Non-Business Entities

Table 1 presents data for all filers across the six types of business returns we examine, and results from the application of our two business tests for tax year 2007.[6] Results are as follows:

- For sole proprietors (Form 1040, Schedule C), 10.7 million filers (46 percent) qualify as a business. Those filers reported the vast majority of total income (94 percent, with average income of $120,200) and net income (80 percent, with an average profit of $20,900).
- For farmers (Form 1040, Schedule F or Form 4835), 1.4 million filers (56 percent) qualify as a business. Those filers reported nearly all total income (98 percent, with average income of $92,200) and net income (98 percent, with an average loss of –$9,200).

[5] Similarly, we exclude any guaranteed payments to partners.

[6] The data are from the IRS Statistics of Income (SOI) individual and business tax files for tax year 2007, http://www.irs.gov/taxstats/index.html?portlet=5. All tax files are stratified random samples weighted to represent national totals. For Schedules C, E, and F, the file contains roughly 325,000 individual tax returns. Data for partnerships are from a sample of roughly 39,900 tax returns, while the S corporation sample includes 34,000 returns and the C corporation sample includes 61,600 returns.

- For rental activity (Form 1040, Schedule E, Part 1), 4.6 million filers (48 percent) qualify as a business. Those filers reported most total income (83 percent, with average income of $46,200) and net income (124 percent, with an average loss of –$4,800).[7]
- For partnerships (Form 1065), 2.3 million entities (74 percent) qualify as a business. They reported nearly all total income (98 percent, with average income of $2.6 million) and net income (94 percent, with an average profit of $615,300).
- For S corporations (Form 1120S), 3.6 million entities (89 percent) qualify as a business. They reported nearly all total income (100 percent, with average income of $1.8 million) and net income (99 percent, with an average profit of $118,000).
- For C corporations (Form 1120), 1.6 million entities (88 percent) qualify as a business. They reported virtually all total income (100 percent, with average income of $13.4 million) and net income (100 percent, with an average profit of $646,100).

At the bottom of Table 1, we show totals for all filers that qualify as a business entity. We retain more than one half (55 percent) of all entities that file a business return. Those entities reported nearly all of the total income and net income of the full population of filers. On average, the entities we exclude from our business group reported $13,500 of total income and $8,200 of net income. Apart from the 800,000 partnerships we exclude (generally because they are income conduits or passive investment vehicles, but report significant gross income), these figures are $6,300 and $1,600. Hence, our business tests generally eliminate a large number of very small filers.

## C. Identification of Small Businesses

In the previous section, we applied two tests to separate filers into business and non-business groups. Those tests represent one possible method of distinguishing businesses from other filers, and we recognize that any such attempt must rely on subjective criteria. Similarly, there is no single definition or unique set of characteristics that should always be used to distinguish small businesses from their larger counterparts; an appropriate definition in one context might be inappropriate for other purposes. The tax code reflects this ambiguity as it contains no explicit definition of small business. Rather, various

[7] To ensure active management of the rental properties, we exclude mortgage interest and depreciation from computed deductions we use for our business tests.

**Table 1**
Business Versus Non-Business Filers
(Tax Year 2007)

| | Number of Filers (Thousand) | Share | Total Income[1] Amount ($Billion) | Total Income[1] Share | Total Income[1] Average Income ($Thousand) | Net Income[1] Amount ($Billion) | Net Income[1] Share | Net Income[1] Average Income ($Thousand) |
|---|---|---|---|---|---|---|---|---|
| All sole proprietors (Schedule C) | 23,175 | 1.00 | 1,371 | 1.00 | 59 | 280 | 1.00 | 12 |
| Business | 10,684 | 0.46 | 1,284 | 0.94 | 120 | 223 | 0.80 | 21 |
| Small business | 10,679 | 0.46 | 1,136 | 0.83 | 106 | 222 | 0.79 | 21 |
| All landlords (Schedule E, rental) | 9,636 | 1.00 | 255 | 1.00 | 26 | –18 | 1.00 | –2 |
| Business | 4,593 | 0.48 | 212 | 0.83 | 46 | –22 | 1.24 | –5 |
| Small business | 4,592 | 0.48 | 208 | 0.82 | 45 | –21 | 1.21 | –5 |
| All farmers (Schedule F) | 2,511 | 1.00 | 134 | 1.00 | 53 | –13 | 1.00 | –5 |
| Business | 1,415 | 0.56 | 130 | 0.98 | 92 | –13 | 0.98 | –9 |
| Small business | 1,415 | 0.56 | 125 | 0.93 | 88 | –13 | 0.96 | –9 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| All partnerships (Form 1065) | 3,096 | 1.00 | 6,172 | 1.00 | 1,993 | 1,512 | 1.00 | 488 |
| Business | 2,300 | 0.74 | 6,048 | 0.98 | 2,630 | 1,415 | 0.94 | 615 |
| Small business | 2,232 | 0.72 | 1,163 | 0.19 | 521 | 167 | 0.11 | 75 |
| All S corporations (Form 1120S) | 3,990 | 1.00 | 6,302 | 1.00 | 1,580 | 424 | 1.00 | 106 |
| Business | 3,554 | 0.89 | 6,295 | 1.00 | 1,771 | 419 | 0.99 | 118 |
| Small business | 3,462 | 0.87 | 2,418 | 0.38 | 698 | 169 | 0.40 | 49 |
| All C corporations (Form 1120) | 1,865 | 1.00 | 22,011 | 1.00 | 11,801 | 1,061 | 1.00 | 569 |
| Business | 1,638 | 0.88 | 22,005 | 1.00 | 13,433 | 1,058 | 1.00 | 646 |
| Small business | 1,563 | 0.84 | 1,405 | 0.06 | 899 | –6 | –0.01 | –4 |
| Total filers | 44,273 | 1.00 | 36,245 | 1.00 | 819 | 3,246 | 1.00 | 73 |
| Business | 24,184 | 0.55 | 35,975 | 0.99 | 1,488 | 3,080 | 0.95 | 127 |
| Small business | 23,942 | 0.54 | 6,455 | 0.18 | 270 | 517 | 0.16 | 22 |

Notes:
(1) Partnerships and S corporations include gross or net rents reported on Form 8825 and all portfolio income from Schedule K.

code sections grant favorable tax treatment to filers based on their level of investment, taxable income, or gross receipts. Some examples follow:[8]

- *Expensing of Investment*
  Under IRC Section 179, for qualified investment placed in service during tax year 2007 (the year from which our data are drawn), eligible firms could expense up to $125,000 of qualified investment — generally machinery, equipment, and software; if firms had qualifying investment that exceeded $500,000, then the expensing deduction was phased-out dollar-for-dollar for investment above that limit.[9]
- *Cash Method Accounting*
  In general, firms that maintain inventories must use the accrual method to compute taxable income (IRC Section 446). In addition, corporations and partnerships with corporate partners may not use cash method accounting. However, an exception is made if average annual gross receipts from the prior three years is less than $5 million, and cash method accounting is extended to firms in "non-inventory intensive" industries if they have average annual gross receipts less than $10 million.
- *Simplified Dollar-Value LIFO*
  Businesses that maintain inventories generally use "first-in-first-out" (FIFO) or "last-in-first-out" (LIFO) inventory valuation methods. Firms with average annual gross receipts of $5 million or less in the previous three years may use the simplified version dollar-value LIFO.

Because many tax code provisions use gross receipts to identify firms that are eligible for preferential treatment, we use a total income threshold to separate small businesses from their larger counterparts. We define total income as the sum of gross receipts, rents, and any portfolio income reported by the firm. We set the small business threshold at $10 million of total income. Because deductions can reflect the scale of operations, we also require that total deductions not exceed $10 million.

### D. Results: Small Businesses

Table 1 presents results from the application of the $10 million total income and deduction threshold to all entities deemed a business. Although the vast majority of business entities also qualify as a small business, they reported only 18 percent of total income and 16 percent of net income reported by all business entities. Not unexpectedly, small businesses reported a larger share of business losses (48 percent) than profits (23

[8] For descriptions of these and other tax code provisions that provide favorable tax treatment to businesses based on size, see Guenther (2010).

[9] Legislation enacted in 2007–2010 raised these limits. For 2008–2009, the maximum deduction is $250,000 with the phase-out starting at $800,000. For 2010–2011, the maximum deduction is $500,000 with the phase-out beginning at $2 million.

percent). Their larger counterparts — comprising only 1 percent of business entities — reported 82 percent or 84 percent of total and net business income.[10]

In Table 2, we separate small businesses into employer and non-employer groups. We classify a small business as an "employer" if labor deductions exceed $10,000.[11] For corporations, we continue to exclude payments to officers from labor expenses. For sole proprietors, we include expenses for "contract labor" because much of those expenses relate to the employment of independent contractors who are similar to employees of the business. (Other business filers do not separately itemize expenses for contract labor.)[12] Finally, we count all filers reporting income on Schedule E, Part 1 (miscellaneous rental real estate) as non-employers, although it is possible that a small proportion have labor expenses in excess of our $10,000 threshold.[13]

Based on these criteria, we find that slightly more than one-fifth of small businesses qualify as an employer. Employers were considerably larger than non-employers, reporting average total income of $922,100, compared to $99,900 for non-employers, and average net income of $45,300, compared to $15,400 for non-employers.

## III. IDENTIFICATION OF SMALL BUSINESS OWNERS

Having identified the entities that meet our small business and employer criteria, the final step in our methodology is to identify the individuals who own those businesses. To do this, we link individual taxpayers to the businesses they own. This task is straightforward for Form 1040 Schedule C, E (rentals), and F filers because those schedules are filed with the individual income tax return. It is more complicated for individuals who report distributions from partnerships and S corporations because we must link the Form 1040 individual income tax return to the business return(s) of the entities they own to ensure that the income is attributable to a small business. This linkage is made possible by newly accessible data from the IRS's Compliance Data Warehouse (CDW). The CDW stores unedited data from all tax returns — business, individual, and information — filed with the IRS.[14]

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[10] If we double the small business threshold from $10 million to $20 million, then we add approximately 110,000 entities, reporting average total income of $13.2 million and average net income of $1.1 million.

[11] For this purpose, we include deductions for wages/salaries reported on the front page of business returns, cost of labor (Schedule A, Cost of Goods Sold), and any wages/salaries reported by partnerships and S corporations on Form 8825.

[12] To the extent that payments for contract labor are also reported as gross receipts on a business tax return by the recipients and the recipients are included in our small business group and counted as an employer, then the number of employers will be overstated.

[13] For Schedule E – Rental filers, we do not have the information necessary to make this computation.

[14] In the previous section, we included C corporations in all small business tabulations. However, we exclude C corporations from our small business owner tabulations because sufficient data are not available to reliably link individuals to the C corporations they own. While some individuals could be linked to their C corporations, the receipt of dividends is an imperfect indicator of C corporation ownership. Unlike S corporations, C corporations need not allocate all earnings to their owners for tax purposes, and many small C corporations choose not to distribute dividends in any given year. Moreover, many C corporations report losses that are trapped at the entity level and not passed through to individuals.

**Table 2**
Small Business Employers
(Tax Year 2007)

| | Number of Firms (Thousand) | Share | Total Income[1] Amount ($Billion) | Total Income[1] Share | Total Income[1] Average Income ($Thousand) | Net Income[1] Amount ($Billion) | Net Income[1] Share | Net Income[1] Average Income ($Thousand) |
|---|---|---|---|---|---|---|---|---|
| All sole proprietors (Schedule C) | | | | | | | | |
| Employers | 1,659 | 0.16 | 579 | 0.51 | 349 | 79 | 0.36 | 48 |
| Non-employers | 9,020 | 0.84 | 558 | 0.49 | 62 | 142 | 0.64 | 16 |
| All landlords (Schedule E, rental)[2] | | | | | | | | |
| Employers | 0 | 0.00 | 0 | 0.00 | 0 | 0 | 0.00 | 0 |
| Non-employers | 4,592 | 1.00 | 208 | 1.00 | 45 | –21 | 1.00 | –5 |
| All farmers (Schedule F) | | | | | | | | |
| Employers | 126 | 0.09 | 52 | 0.42 | 414 | –3 | 0.20 | –21 |
| Non-employers | 1,289 | 0.91 | 73 | 0.58 | 56 | –10 | 0.80 | –8 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| All partnerships (Form 1065) | | | | | | | | |
| Employers | 533 | 0.24 | 648 | 0.56 | 1,215 | 45 | 0.27 | 84 |
| Non-employers | 1,698 | 0.76 | 515 | 0.44 | 303 | 122 | 0.73 | 72 |
| All S corporations (Form 1120S) | | | | | | | | |
| Employers | 1,760 | 0.51 | 2,047 | 0.85 | 1,163 | 110 | 0.65 | 63 |
| Non-employers | 1,702 | 0.49 | 371 | 0.15 | 218 | 58 | 0.35 | 34 |
| All C corporations (Form 1120) | | | | | | | | |
| Employers | 864 | 0.55 | 1,232 | 0.88 | 1,425 | –8 | 1.44 | –10 |
| Non-employers | 699 | 0.45 | 174 | 0.12 | 249 | 3 | –0.44 | 4 |
| Total filers | | | | | | | | |
| Employers | 4,942 | 0.21 | 4,557 | 0.71 | 922 | 224 | 0.43 | 45 |
| Non-employers | 19,000 | 0.79 | 1,898 | 0.29 | 100 | 293 | 0.57 | 15 |

Notes:
(1) Partnerships and S corporations include gross or net rents reported on Form 8825 and all portfolio income from Schedule K.
(2) Schedule E Rental Income filers do not itemize expenses related to the employment of individuals. For the purposes of this table, we count all Schedule E-Rental Income filers as non-employers.

### A. Matching Partners and S Corporation Shareholders to Their Business Entities

We start with the nationally representative sample of individual income tax returns known as the 2007 Individual Sole Proprietorship (INSOLE) tax file prepared by SOI.[15] For all individuals reporting S corporation or partnership income or loss, we attempt to match the Employer Identification Numbers (EINs) they report on Schedule E for each partnership or S corporation from which they receive income to the EINs of business on the CDW.[16] We can then determine whether the income reported on the individual tax return is from a business, small business, or small business employer. We find that the majority of individual partners and S corporation shareholders — 80 percent — own businesses that are small, but that only about half of the net partnership and S corporation income comes from small businesses.[17] By comparison, 13 percent of individuals own S corporations and partnerships too large to be considered small, and they reported the other half of the net partnership and S corporation income.[18] In addition, we find that one-third of partners and shareholders own a small business employer. Those businesses reported 31 percent of partnership and S corporation net income passed through to individuals and reported on Schedule E of Form 1040.

### B. Defining Small Business Owners

Having identified the owners of small business partnerships and S corporations, we then combine those results with small business income attributable to sole proprietorships, farming, and rental real estate activities. However, merely identifying individuals who report income from a small business is insufficient to deem the individual a "small business owner." We must also consider several other issues, including:

- *Owners of Both Large and Small Businesses*
  If filers own multiple businesses, some small and some not small, when should they be considered small business owners: if they own any small business, regardless of other ownership, or only if their small business income bears some specific relationship to their large business income? What if they own multiple small businesses that, added together, would not be small?

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[15] This stratified sample of returns includes roughly 325,000 individual income tax returns.

[16] We are able to match 94 percent of the entities and 96 percent of the income reported on the partnership and S corporation section of the Schedule E.

[17] These individuals might own both small and large businesses.

[18] Some individuals receive income from both small and larger S corporations and partnerships, and a few receive income from entities that do not qualify as businesses.

- *Active vs. Passive Income*
  Should owners with passive interests be deemed small business owners, or only those who actively participate in the business? Passive investors often provide the capital that makes a business possible; changes in tax policy that affect the after-tax return on their investments might influence their willingness to invest. However, popular discussions of small business owners often focus on active owners who make the operating decisions.
- *Significance of Business Income Relative to Adjusted Gross Income (AGI)*
  Should income from the small business be "material" for the filer to be considered a "small business owner"? Or does any amount of small business income make someone a "small business owner"?

Because there are no obvious answers to these questions, we use two possible definitions of small business owner. Under our "broad" definition, we include anyone who reports income or loss from an entity that meets our definition of small business. Under our "narrow" definition, we only include individuals whose active income or loss from small business represents at least 25 percent of their AGI; all passive income and losses are disregarded. Under both definitions, small business owners may also own large or even very large businesses.

## C. Results: Small Business Owners

Tables 3 and 4 present our results by AGI class, while Table 5 uses statutory marginal tax rates (MTRs). Table 3 compares distributions of tax returns across four groups: all returns; returns with any flow-through net income (our former approach); and small business owners under our broad and narrow definitions.[19] We focus on taxpayers who report more than $200,000 of AGI or are subject to the top two rate brackets because those taxpayers are affected by the Administration's proposal in the fiscal year 2012 budget. For tax year 2007, 3 percent of all returns reporting 33 percent of total AGI were filed by taxpayers with AGI over $200,000. For taxpayers with any flow-through income, 8 percent of returns reporting 75 percent of net flow-through income reported AGI over $200,000. If we further restrict our focus to small business owners (the broad definition), then 11 percent of returns reporting 64 percent of small business income reported AGI over $200,000. Using the narrow definition of small business owner,

[19] Tables available from the authors upon request also show distributions for all business owners and business owners with income or loss from businesses too big to be considered small under our definition. (Note that business owners in this final group might also own small businesses and be counted as small business owners.)

**Table 3**
Distribution of Individual Tax Returns by AGI
(Tax Year 2007)

| | All Tax Returns | | | | Returns with Any Flow-Through Income[1] | | | |
|---|---|---|---|---|---|---|---|---|
| | | | AGI | | | | Flow-Through Income | |
| AGI | Number of Returns (Thousand) | Share | Amount ($Billion) | Share | Number of Returns (Thousands) | Share | Amount ($Billion) | Share |
| Under 0 | 1,476 | 0.01 | –110 | –0.01 | 1,149 | 0.03 | –73 | –0.11 |
| 0–50,000 | 92,275 | 0.65 | 1,949 | 0.22 | 16,714 | 0.48 | 74 | 0.11 |
| 50,000–100,000 | 31,185 | 0.22 | 2,209 | 0.25 | 8,729 | 0.25 | 63 | 0.10 |
| 100,000–200,000 | 13,505 | 0.09 | 1,800 | 0.21 | 5,259 | 0.15 | 98 | 0.15 |
| 200,000–500,000 | 3,494 | 0.02 | 1,005 | 0.12 | 2,066 | 0.06 | 148 | 0.22 |
| 500,000–1 million | 651 | 0.00 | 442 | 0.05 | 491 | 0.01 | 94 | 0.14 |
| >1 million | 392 | 0.00 | 1,401 | 0.16 | 331 | 0.01 | 258 | 0.39 |
| Total | 142,979 | 1.00 | 8,695 | 1.00 | 34,740 | 1.00 | 662 | 1.00 |
| Addendum: | | | | | | | | |
| >$200,000 | 4,538 | 0.03 | 2,848 | 0.33 | 2,888 | 0.08 | 500 | 0.75 |
| >$500,000 | 1,043 | 0.01 | 1,843 | 0.21 | 822 | 0.02 | 352 | 0.53 |

| AGI | Small Business Owners — Broad[2]: Number of Returns (Thousand) | Share | Small Business Income: Amount ($Billion) | Share | Small Business Owners — Narrow[3]: Number of Returns (Thousand) | Share | Small Business Income: Amount ($Billion) | Share |
|---|---|---|---|---|---|---|---|---|
| Under 0 | 983 | 0.05 | –48 | –0.13 | 670 | 0.07 | –38 | –0.11 |
| 0–50,000 | 8,466 | 0.42 | 45 | 0.12 | 5,388 | 0.57 | 51 | 0.15 |
| 50,000–100,000 | 4,948 | 0.25 | 54 | 0.14 | 1,633 | 0.17 | 55 | 0.16 |
| 100,000–200,000 | 3,341 | 0.17 | 83 | 0.22 | 991 | 0.11 | 76 | 0.23 |
| 200,000–500,000 | 1,606 | 0.08 | 117 | 0.31 | 540 | 0.06 | 99 | 0.30 |
| 500,000–1 million | 399 | 0.02 | 58 | 0.15 | 116 | 0.01 | 45 | 0.13 |
| >1 million | 273 | 0.01 | 67 | 0.18 | 51 | 0.01 | 47 | 0.14 |
| Total | 20,016 | 1.00 | 376 | 1.00 | 9,390 | 1.00 | 335 | 1.00 |
| Addendum: | | | | | | | | |
| >$200,000 | 2,278 | 0.11 | 242 | 0.64 | 707 | 0.08 | 191 | 0.57 |
| >$500,000 | 672 | 0.03 | 125 | 0.33 | 167 | 0.02 | 92 | 0.27 |

Notes:
(1) This measure includes income or loss from Schedule C, E-rental, F, partnership, and S corporation income as reported on Schedule E Part II.
(2) This category includes any individual with income or loss from a business that meets our definition of a "small business."
(3) This category includes only individuals with active net income from small businesses that equals at least 25 percent of the taxpayer's AGI.

**Table 4**
Sources of Income for Small Business Owners by AGI Class
(Tax Year 2007)

| AGI Class | Number of Owners (Thousand) | Share | Sources of Total Income | | | | | Share |
|---|---|---|---|---|---|---|---|---|
| | | | Wages/ Salaries[1] ($Billion) | Small Business Income ($Billion) | Gains, Interest and Dividends ($Billion) | Other[2] ($Billion) | Total Income ($Billion) | |
| Small business owners — broad[3] | | | | | | | | |
| Under 0 | 983 | 0.05 | 12 | –48 | 20 | –77 | –93 | –0.03 |
| 0–50,000 | 8,466 | 0.42 | 119 | 45 | 14 | 33 | 211 | 0.07 |
| 50,000–100,000 | 4,948 | 0.25 | 228 | 54 | 26 | 65 | 373 | 0.13 |
| 100,000–200,000 | 3,341 | 0.17 | 266 | 83 | 47 | 82 | 478 | 0.17 |
| 200,000–500,000 | 1,606 | 0.08 | 228 | 117 | 77 | 73 | 495 | 0.18 |
| 500,000–1 million | 399 | 0.02 | 106 | 58 | 68 | 47 | 279 | 0.10 |
| >1 million | 273 | 0.01 | 217 | 67 | 541 | 250 | 1,075 | 0.38 |
| All returns | 20,016 | 1.00 | 1,176 | 376 | 792 | 474 | 2,818 | 1.00 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Small business owners — narrow[4] | | | | | | | | |
| Under 0 | 670 | 0.07 | 9 | –38 | 11 | –21 | –39 | –0.05 |
| 0–50,000 | 5,388 | 0.57 | 54 | 51 | 7 | 10 | 122 | 0.17 |
| 50,000–100,000 | 1,633 | 0.17 | 52 | 55 | 8 | 12 | 127 | 0.18 |
| 100,000–200,000 | 991 | 0.11 | 47 | 76 | 12 | 15 | 150 | 0.21 |
| 200,000–500,000 | 540 | 0.06 | 43 | 99 | 16 | 14 | 173 | 0.24 |
| 500,000–1 million | 116 | 0.01 | 18 | 45 | 12 | 7 | 82 | 0.11 |
| >1 million | 51 | 0.01 | 15 | 47 | 28 | 13 | 102 | 0.14 |
| All returns | 9,390 | 1.00 | 238 | 335 | 94 | 50 | 716 | 1.00 |

Notes:
(1) Wages/salaries could include officer compensation for S corporation owners and wages attributable to spouses.
(2) Other income includes flow-through income from entities that do not meet the small business definition.
(3) This category includes any individual with income or loss from a business that meets our definition of a “small business.”
(4) This category includes only individuals with active net income from small businesses that equals at least 25 percent of the taxpayer’s AGI.

8 percent of returns reporting 57 percent of narrowly defined small business income reported AGI over $200,000.[20]

Table 4 presents the sources of income by AGI class for small business owners under the broad and narrow definitions. This table highlights the importance of wages and other forms of income for both sets of small business owners.[21] This is less true under the narrow definition of small business owner because small business income must represent at least 25 percent of AGI for those taxpayers. Also notable is the fact that net small business income comprises only 13 percent of total income under the broad definition, but nearly half under the narrow definition.

Table 5 presents statutory MTRs faced by all filers, filers with any flow-through income, and small business owners.[22] We note that the tabulations in Table 5 include all business losses passed through to individuals, as long as total taxable income reported remains positive.[23] It seems reasonable to consider both positive and negative sources of business income — as long as the taxpayer has positive taxable income — because the tax value of losses varies with the taxpayer's MTR. Table 5 also shows taxpayers who have Alternative Minimum Tax (AMT) liability and so face MTRs of 26 percent or 28 percent.

Across all tax returns, Table 5 shows that 1 percent of taxpayers with positive taxable income faced the 33 percent or 35 percent MTR for tax year 2007. That share increases to 3 percent or 4 percent for taxpayers with any flow-through income and owners of small businesses (broad and narrow definitions).[24] In terms of income, a smaller share of net small business income went to taxpayers in the top brackets — 32 (broad) percent or 29 (narrow) percent — compared to 50 percent of all flow-through income (our former approach).[25]

[20] Taxpayers owning any business too big to meet the broad definition of small business — "owners of any larger business" — are more concentrated in the upper income groups (49 percent have AGI of at least $200,000) and report more than 100 percent of the net income from larger businesses (due to net losses and small amounts of positive income reported by lower AGI classes).

[21] Wages and salaries could include officer compensation for S corporation owners.

[22] The statutory MTR is the rate applicable to the last dollar of taxable income. That rate may or may not equal the "effective marginal tax rate" depending on certain phase-outs and credits.

[23] Table 5 excludes filers who fail to report any positive taxable income (i.e., a 0 percent statutory tax rate). For small business owners, this could result from business losses that cannot be used to offset taxable income. Inclusion of those filers would effectively double count the impact of unused business losses for small business owners because our tabulations also reflect unused business losses carried forward from prior years that are used to offset current year taxable income. For all filers, this omission excludes 32.3 million filers reporting $198 billion of AGI. For our broad (narrow) definition of small business owner, 4.9 million (3.6 million) owners are excluded who reported –$37 billion (–$21 billion) of small business income.

[24] The share rises to 20 percent for owners of non-small businesses.

[25] For owners of larger businesses, 86 percent of net income from those businesses went to taxpayers in the top two rate brackets.

### D. Comparison with Other Analyses

To the extent that our analysis is similar to methodologies used by other studies, we find that the results are generally comparable. For example, the staff of the Joint Committee on Taxation estimates that in 2011 just under 750,000 taxpayers with net positive business income (3 percent of all taxpayers with net positive business income) would be affected by the President's proposal to let the top MTRs rise to 36 percent or 39.6 percent. The JCT estimates those taxpayers would report half of the approximately $1 trillion of aggregate net positive business income. Similarly, the Tax Policy Center estimates that 3.2 percent of tax units reporting business income (positive and negative) would be affected by the "Administration's upper-income tax proposals," and those taxpayers would report 44 percent of positive business income (net negative business income is not included).

Although the precise numbers of taxpayers with flow-through income (business income as defined by the JCT or TPC) and the dollar amount of that income in the top rate brackets varies among the three analyses, the conclusions are broadly consistent: about 3 percent of taxpayers with any flow-through income fall into the top two rate brackets, either in 2007 or under proposed 2011 law, and they report a substantial share of all flow-through income (45 to 50 percent). However, as shown by Table 5, once we remove larger business entities from the analysis, the income share falls to 29–32 percent depending on how one defines small business owners.

## IV. POTENTIAL IMPLICATIONS OF BUSINESS TAX REFORM

It is well known that the "classical" system under which C corporations are taxed provides them with very different incentives than those facing business entities that elect pass-through treatment. Under the classical system, the business entity is treated as separate and distinct from the owners. As such, tax is levied on the profits of the entity and also on shareholders when profits are distributed as dividends or are realized upon the sale of shares as capital gains. This (partial) double taxation provides a strong incentive for businesses to avoid the C corporation form if the firm need not offer shares to the general public to obtain capital. The two-tiered tax regime also encourages firms to retain earnings rather than pay dividends. Debt is favored over the issuance of equity because interest payments can be deducted by the firm, but dividends paid cannot. Largely due to the (partial) double tax on earnings, studies find that the effective MTR on corporate investment is considerably higher than non-corporate (i.e., pass-through) investment. For example, a recent study by the U.S. Treasury (2007) finds that the effective MTR on corporate investment is approximately 9 percentage points higher than non-corporate investment.

In order to eliminate the partial double tax on corporate investment and various tax-induced distortions, many analysts have recommended integration of the corporate and individual income tax systems. Although integration can take many forms, one

**Table 5**

Distribution of Individual Tax Returns with Taxable Income by Statutory Marginal Tax Rate[1]
(Tax Year 2007)

| | All Tax Returns | | | | With Any Flow-Through Income[2] | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Adjusted Gross Income | | | | Flow-Through Income | |
| Statutory MTR[1] | Number of Returns (Thousand) | Share | Dollar Amount ($Billion) | Share | Number of Returns (Thousand) | Share | Dollar Amount ($Billion) | Share |
| 10 Percent | 27,575 | 0.25 | 554 | 0.07 | 4,676 | 0.18 | 22 | 0.03 |
| 15 Percent | 50,542 | 0.46 | 2,362 | 0.28 | 10,498 | 0.41 | 63 | 0.09 |
| 25 Percent | 23,547 | 0.21 | 2,109 | 0.25 | 6,144 | 0.24 | 78 | 0.11 |
| 28 Percent | 3,692 | 0.03 | 565 | 0.07 | 1,408 | 0.05 | 44 | 0.06 |
| 33 Percent | 512 | 0.00 | 134 | 0.02 | 302 | 0.01 | 25 | 0.04 |
| 35 Percent | 679 | 0.01 | 1,242 | 0.15 | 521 | 0.02 | 329 | 0.47 |
| AMT 26 Percent | 1,164 | 0.01 | 154 | 0.02 | 486 | 0.02 | 9 | 0.01 |
| AMT 28 Percent | 2,996 | 0.03 | 1,376 | 0.16 | 1,849 | 0.07 | 136 | 0.19 |
| All returns | 110,707 | 1.00 | 8,497 | 1.00 | 25,884 | 1.00 | 705 | 1.00 |
| 33 and 35 Percent rates | 1,191 | 0.01 | 1,376 | 0.16 | 823 | 0.03 | 353 | 0.50 |
| Weighted average MTR | | 0.17 | | 0.24 | | 0.19 | | 0.29 |

| | Small Business Owners — Broad[3] | | | | Small Business Owners — Narrow[4] | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Small Business Income | | | | Small Business Income | |
| Statutory MTR[1] | Number of Returns (Thousand) | Share | Dollar Amount ($Billion) | Share | Number of Returns (Thousand) | Share | Dollar Amount ($Billion) | Share |
| 10 Percent | 2,604 | 0.17 | 16 | 0.04 | 1,522 | 0.26 | 17 | 0.05 |
| 15 Percent | 5,659 | 0.37 | 53 | 0.13 | 2,236 | 0.38 | 55 | 0.15 |
| 25 Percent | 3,494 | 0.23 | 67 | 0.16 | 1,027 | 0.18 | 62 | 0.17 |
| 28 Percent | 947 | 0.06 | 37 | 0.09 | 304 | 0.05 | 33 | 0.09 |
| 33 Percent | 237 | 0.02 | 20 | 0.05 | 103 | 0.02 | 18 | 0.05 |
| 35 Percent | 422 | 0.03 | 113 | 0.27 | 136 | 0.02 | 86 | 0.24 |
| AMT 26 Percent | 344 | 0.02 | 7 | 0.02 | 96 | 0.02 | 6 | 0.02 |
| AMT 28 Percent | 1,441 | 0.10 | 100 | 0.24 | 403 | 0.07 | 78 | 0.22 |
| All returns | 15,148 | 1.00 | 412 | 1.00 | 5,828 | 1.00 | 356 | 1.00 |
| 33 and 35 Percent rates | 659 | 0.04 | 133 | 0.32 | 239 | 0.04 | 105 | 0.29 |
| Weighted average MTR | | 0.20 | | 0.27 | | 0.18 | | 0.27 |

Notes:
(1) The statutory MTR is the statutory rate applicable to the last dollar of taxable income.
(2) This measure includes net income from Schedule C, E-Rental, F, partnership, and S corporation income as reported on Schedule E Part II.
(3) This category includes any individual with income or loss from a business that meets our definition of a "small business."
(4) This category includes only individuals with active net income from small businesses that equals at least 25 percent of taxpayer's AGI.

prototype applies a single tax rate to all business income regardless of form. Under this form of integration, dividends and interest paid are not deductible by the firm, but they are also exempt to recipients. Hence, this integration prototype eliminates the tax bias against the corporate form in addition to the biases that favors debt over equity and retained earnings over dividends. This version of integration is known generally as the Comprehensive Business Income Tax (CBIT). More recently, the 2005 Tax Reform Panel proposed a business-level cash flow tax under which all business income would be treated similarly (President's Advisory Panel on Federal Tax Reform, 2005).[26]

How might this form of integration affect small business owners? To provide insight into that question, we consider the impact of levying a single tax rate on all ordinary business income reported by business entities, regardless of organizational form. We assume that the single rate would be equal to, or perhaps slightly less than 35 percent, the maximum individual income tax rate for tax year 2007, the year from which our data are drawn. Although CBIT-type integration also denies the deduction for interest payments on debt, the implications of that denial are beyond the scope of this analysis. Denial of the interest deduction would increase the effective tax rate we compute under our reform alternative, but many small business owners would also benefit because interest and dividends received by individuals would be non-taxable. Finally, we assume that no other changes are made to the individual income tax system, and we consider only the impact on statutory MTRs faced by small business owners reporting profits or losses.[27]

The results in Table 5 suggest that most small business income and owners might face higher MTRs under a system that levied a single rate close to the top individual tax rate. That result is based on a simple computation of average statutory MTRs from Table 5, weighted by the number of filers (return-weighted) or the appropriate measure of income (dollar-weighted using AGI, all flow-through income, or small business income). Regardless of the group we consider, return-weighted MTRs are 7 to 10 percentage points lower than dollar-weighted rates because income is more concentrated in upper brackets than are owners. (See Table 5 for computations.) Dollar-weighted MTRs levied on small business income (27 percent) are considerably lower than the top individual rate (35 percent for 2007).[28] Computations for owners of businesses too large to be considered small (a dollar-weighted rate of 34 percent, not shown in Table 5) suggest a much smaller impact for those taxpayers.

This simple comparison likely overstates the higher tax burden that small business owners might face under a single entity-level business tax. Many owners would have incentives to recharacterize business profits as wages or interest — if interest were still deductible — if the business tax rate exceeds their personal rate. Moreover, much like

[26] The Tax Panel's proposal allows an immediate deduction for capital expenditures, thereby transforming the levy into a quasi-consumption tax.

[27] For the purposes of this simple analysis, we do not compare the average tax burden on small business income under the two systems. However, due to the lack of a graduated rate structure, it is very likely that the average tax burden on small business income would be higher under our stylized reform alternative.

[28] If we include small business owners who faced a zero statutory MTR, then the return-weighted averages would fall by 5 to 6 percentage points, but the dollar-weighted rates would remain largely unchanged.

the current corporate income tax, the business tax might use a graduated rate structure to encourage progressivity. However, graduated rates could inadvertently benefit "large" firms and would encourage certain owners — those receiving wage payments from the firm and with personal rates above the graduated business rates — to recharacterize wage income as business income.

Although less obvious, it is likely that small business owners reporting losses would also face higher MTRs under a single entity-level tax. Under current law, and as reflected in the tabulations in Table 5, active business losses passed through to individuals are generally available to offset other sources of taxable income.[29] To the extent that business losses were immediately passed through to owners and used, the impact of those losses is reflected in our weighted average MTR computations. For tax year 2007, tax data show that roughly three-quarters of active business losses passed through from partnerships and S corporations were used immediately by their owners to offset other forms of income. Residual business losses not used to offset current year income can be carried back up to two tax years or carried forward up to 20 years to offset prior or future tax liability; the great majority of unused business losses are carried forward. If one-half of those amounts are eventually used, then business loss utilization rates for pass-through entities might approach 85–90 percent.

By contrast, an entity-level tax traps losses at the entity level, and those losses cannot be used until the firm generates taxable income. Cooper and Knittel (2010) suggest that the trapping of losses at the business entity level is much less generous than pass-through treatment, finding that C corporations use perhaps 60–70 percent of their tax losses depending on the industry and age of the firm; cyclical industries and young firms generally have much lower utilization rates. The study also finds that young firms require 3.9 years on average to fully use a tax loss, while mature firms require only 2.5 years. Due to the partial utilization of tax losses and delays in usage, the study concludes that the real value of C corporation tax losses might be eroded by half. This "partial refunding" of tax losses increases the effective MTR on investment and discriminates against riskier investments.

If small businesses experienced loss utilization patterns similar to those of C corporations, this outcome would reinforce the likelihood that many small business owners and their income would face higher MTRs under the entity-level tax system we have assumed. This outcome would likely discourage start-ups, entrepreneurial activity, and business expansion.

## V. CONCLUSION

To analyze the potential implications of one possible business tax reform prototype, we present a methodology to improve the identification of small businesses and their owners. In Section II, we use tests to separate business from non-business entities and

[29] Passive losses in excess of passive income are disallowed until the individual either has sufficient passive income to use the losses, or the individual disposes of their interest in the loss-producing property.

find that a little more than half of the 44 million entities that file a business tax return conform to our definition of a business. Using a $10 million gross income and deduction test, we find that 99 percent of the entities deemed a business (54 percent of total filers) are also a small business, and they reported 18 percent of total business income and 16 percent of net business income for tax year 2007. Their larger counterparts (comprising 1 percent of all business entities) reported the rest.

In Section III, we apply our small business criteria to newly accessible data to link income reported by small businesses to their respective owner(s). Previously, all taxpayers reporting flow-through income were counted as small business owners. Under that approach, there were 34.7 million small business owners reporting $662 billion of net business income for tax year 2007. Of those taxpayers, 8 percent — with three-quarters of net business income — reported AGI greater than $200,000. Using our revised methodology and our broad measure of small business owner, we identify 20.0 million small business owners reporting $376 billion of net small business income. With this measure, 11 percent — with nearly two-thirds of net small business income — reported AGI greater than $200,000. Using our narrow definition of small business owner, we identify 9.4 million small business owners reporting $335 billion of net small business income. Of those filers, 8 percent — with slightly more than one-half of net small business income — had AGI greater than $200,000.

In Table 5, we present tabulations based on statutory MTRs. For filers who reported any flow-through income, 3 percent of filers reporting half of flow-through net income faced the top two rates. Using our broad definition of small business owner, 4 percent of filers reporting nearly one-third of small business net income faced the top two rates; using our narrow definition, those figures are 4 percent and 29 percent, respectively. Our revised methodology reduces the relative share of small business income subject to the highest tax rate brackets because it excludes income passed through from business entities that report income or deductions in excess of $10 million.

Section IV uses the results from our revised methodology in a simple analysis of how small business owners might fare under a stylized version of business tax reform that levies a single rate on all business income regardless of form or size. Our results suggest that most small business owners and small business income would face higher MTRs if the single business rate were set equal to, or slightly less than, the maximum individual income tax rate. However, as discussed in the previous section, our analysis makes many simplifying assumptions that may or may not hold under an actual business reform proposal.

In conclusion, the current definition of a small business owner is highly flawed because it includes millions of non-business entities and owners of very large businesses. Although our methodology is but one approach that could be used to identify small business owners, it demonstrates that a nuanced approach is needed to accurately gauge the potential implications of tax reform proposals on small businesses and their owners.

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