



## 'SMALL BUSINESS' AND TOP MARGINAL RATES

### Tax filers affected by proposed rate increases are not necessarily small, or businesses, or job creators

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The Bush-era tax cuts enacted in 2001 and 2003 are set to expire once again, this time at the end of calendar year 2012, and an argument heard repeatedly is that returning the top two marginal income tax rates to 36 and 39.6 percent (from 33 and 35 percent) will drag on job creation by “small businesses.” House Speaker John Boehner (R-Ohio), for example, has maintained on numerous occasions that raising these tax rates will destroy 700,000 jobs, a claim that has been debunked.<sup>1</sup>

This paper explores the relationship between rising top marginal rates and small businesses and finds the following:

- The way that small businesses are defined for tax purposes has been put to use in this debate in a manner that is misleading. The default definition of “small business” in the tax debate can often identify many entities that are neither small nor even businesses.
- Even under this broad definition only a fraction of small businesses would be affected by tax rate increases at the top.
- Small businesses do not represent a significant share of job creation, though new businesses do.
- Small businesses already enjoy preferential treatment in the tax code through provisions that favor the way they are organized and operate.

- The best way to boost American small businesses is to address the demand shortfall that keeps unemployment high and to strengthen the social safety net in ways that can encourage entrepreneurial initiative.

## The definition applied to ‘small business’ can be misleading

When politicians or pundits talk about small businesses with respect to the tax code, it is important to remember that the specific ways in which the tax code delineates small businesses are not necessarily the way we may conceive of them. The typical “mom and pop” shop is most likely a small business, but in fact the tax code captures many more individuals, businesses, and income under this moniker than just the neighborhood corner store.

Businesses can choose to report their income under the individual income tax system or the corporate tax system. Businesses that elect to organize and file as pass-through entities (also referred to as flow-through entities, because business income flows straight into individual income for tax purposes) are subject to the individual income tax; specifically, shareholders or partners in these firms include their share of profits in their taxable income under the individual income tax code. Pass-through businesses refer to an array of organizational structures, notably sole proprietorships, S corporations, and partnerships. Many businesses, however, choose instead to file as corporations (subchapter C of the Internal Revenue Code). In fact, more business income is subjected to the corporate tax rather than the individual income tax (TPC 2008), and business income taxed at the corporate rate is not affected by the rise in the top two brackets of the individual tax code.

Over the past few decades, both the proportion of firms organized as pass-through entities and their share of business receipts have increased, from 83 percent of firms and 14 percent of business receipts in 1980 to 94 percent of firms and 38 percent of business receipts in 2007 (CBO 2012b). These shifts have been driven by changes in the

tax code—such as lowering the top marginal income tax rate below the top marginal corporate income tax rate—as well as movement in the economy from manufacturing toward providing goods and services.

Under the definitions employed in the current debate over the expiring Bush tax cuts, *any* taxpayer who declares *any* income derived from these pass-through income flows is considered a “small business.” There are obvious problems in equating a pass-through entity with a small business in this context.

For example, many of the “business” filers who would be subject to higher rates are a subgroup called sole proprietors, an umbrella definition that captures a vast and varied number of individuals and businesses. In 2011, there were over 24 million tax “units” identifying as sole proprietors, and around 175,000 of these fell into the 33 and 35 percent brackets (TPC 2011a). Sole proprietorships, which are the simplest form under which one can operate a business, are unincorporated and relatively easy to operate; under this arrangement a person and his or her activity are one entity in regard to income taxes. Accordingly, this has proven to be an increasingly popular way to set up a business. However, because the definition of a small business includes taxpayers who receive any income from any type of pass-through entity, proponents of individual income tax cuts can argue that rate increases would affect a huge swath of “small businesses.” They then make the jump that higher taxes on these filers will stifle job creation on a large scale.

The ability of many of these businesses/tax filers to add to employment is not affected, however, because *many do not actually employ anyone*. Sole proprietors may, for instance, be people who earn income from rental properties, or they may be artists or musicians, financial planners, or independent contractors or consultants. While these activities may technically be businesses, in most cases this status is simply reflective of a different method by which workers are selling their labor or capital. And by their very organization, there is no scope for these sole proprietors

to expand their payrolls—these are jobs or part-time jobs, not job creators.

Besides misleadingly classifying individual workers who are in a sense “too small” to really qualify as a “business,” the prevailing definition also includes businesses that are clearly not small. In fact, many very large businesses organize and report income as pass-through entities. While the share of large firms that do so is small, the share of pass-through economic activity these firms are responsible for is quite big. In 2005, for example, only 0.8 percent of partnerships had revenues over \$50 million, but they accounted for the majority of partnership assets—around 76 percent. Less than one half of 1 percent of both S corporations and partnerships combined had more than \$50 million in assets in 2005, yet they accounted for just under 70 percent of S corporation and partnership assets (Marron 2011).

Additionally, the tax code definition of small business can end up referring to very wealthy individuals. The Center on Budget and Policy Priorities (CBPP) illustrates this by noting that both President Obama and GOP candidate Mitt Romney “would count as small business owners—as would 237 of the nation’s 400 wealthiest people” (Huang and Marr 2012).<sup>2</sup> The top 400 income earners in the country—who in 2009 reported an average of \$83.7 million in partnership and S corporation net income—are obviously not the neighborhood “mom-and-pop” businesses that one may think of when they hear that small businesses would be impacted by higher tax rates (IRS 2009).

A recent Treasury Department study, which developed a more narrow way of defining small businesses, found that just 2.5 percent of small business owners fall under the top rate brackets, and even then very little of high-income taxpayers’ income—7.6 percent—actually came from properly defined small businesses.<sup>3</sup> Furthermore, only 5.6 percent of their income came from small businesses that actually employed people, and only slightly more than one-fifth of small businesses qualified, under

this narrow definition, as employers (Treasury Department 2011; Huang and Marr 2012).

In sum, giving preferential treatment to high-income tax filers provides a benefit that is largely unrelated to small business income. It instead operates more as a tax cut for high-income filers.

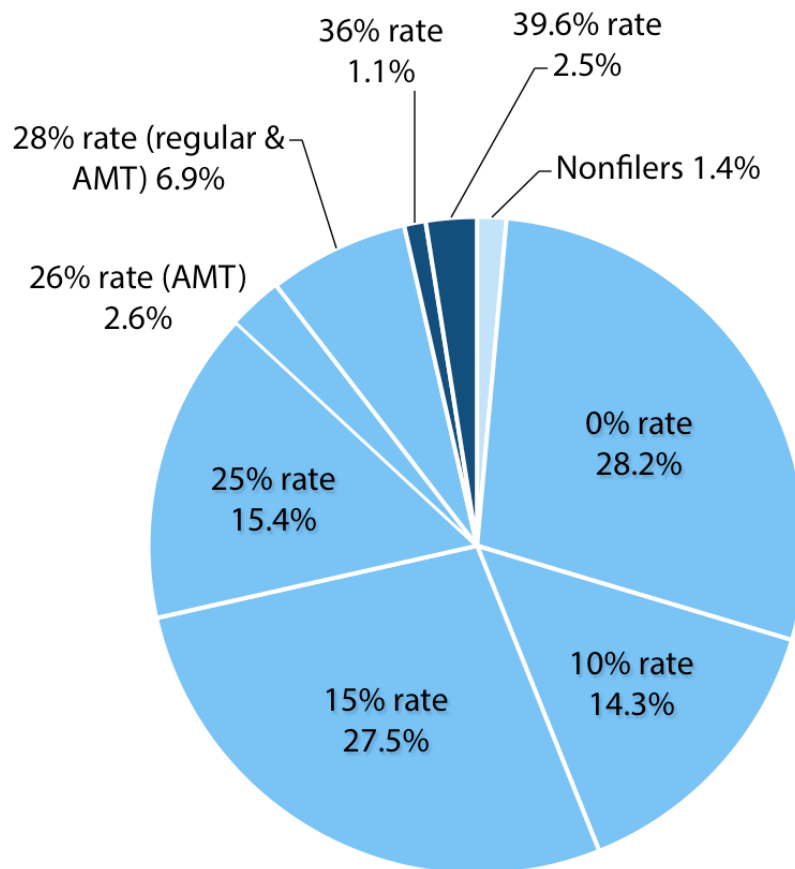
## **Only a fraction of small businesses would be affected by rate increases at the top**

Even though politicians and pundits often claim otherwise, an increase in the marginal income tax rates in the top two tax brackets would affect a very small number of small businesses, even under the flawed definition. Though it is true that the share of businesses organized as pass-through entities (and additionally the share of business receipts in pass-through enterprises) has been rising over time (TPC 2008; CBO 2012b), numerous studies show that an increase in marginal income tax rates at the top would affect relatively few of them:

- The Joint Committee on Taxation (JCT) estimated in a 2010 report on President Obama’s individual income tax proposals that in 2011 his plan to raise the top two federal income tax rates would subject 3 percent of taxpayers with net positive business income to a tax increase (JCT 2010).<sup>4</sup> Note that this 3 percent does not exclusively mean small businesses, but rather any individual or business filing as a pass-through. In fact, in 2005 almost 13,000 S corporations and over 6,500 partnerships—both taxed as pass-through entities—had receipts exceeding \$50 million (JCT 2010).<sup>5</sup>
- Data from Tax Policy Center (TPC) analyses show similar trends. In 2011, TPC reported that, using a baseline of current policy adjusted for the Obama administration upper-income tax proposals,<sup>6</sup> only 3.6 percent of tax returns reporting business income

FIGURE A

Share of tax returns with business income affected by upper-income tax increases, 2011



**Note:** The chart shows the share of tax returns reporting business income under the individual income tax system, i.e., as "flow-through" or "pass-through" entities (sole proprietorships under Schedule C, partnerships under Schedule E, and S corporations under Schedule E) that fall in certain tax rate brackets. The administration proposes to extend tax cuts to all tax brackets except those currently taxed at the 33 percent rate (their rate would return to 36 percent) and the 35 percent rate (their rate would return to 39.6 percent) for married taxpayers with income over \$250,000 (\$200,000 for singles). The administration also proposes reinstating the limitation on itemized deductions and the personal exemption phase-out for married taxpayers with income over the threshold; and imposing a 20 percent tax rate on capital gains and qualified dividends for taxpayers in the top two tax brackets.

**Source:** Tax Policy Center 2010

would fall in the top two rate brackets (see **Figure A**) (TPC 2010).

- Gravelle (2010), using TPC and JCT data, found that only a minor portion of businesses—between 2.5 and 3.5 percent—would be affected by President Obama’s changes to the top two rates. She also found that 80 percent or more of the benefits of lower rates for the top two brackets accrue to non-business

income, and suggests that tax cuts targeted to either high-income individuals or high-income businesses would not be highly stimulative for the economy in times of recession (Gravelle 2010). Given that the Bush tax cuts were not designed to be stimulative, this is a logical conclusion. Bivens and Fieldhouse (2012) estimate that the fiscal multiplier (i.e., how much economic activity is generated per dollar spent

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on an economic policy) for the upper-income portion of the Bush tax cuts is 0.25—25 cents per dollar spent—relatively low compared with the economic impacts of other tax policies (see Table 1 in Bivens and Fieldhouse 2012).

## Are small businesses the top job creators?

The idea that small firms are the primary job creators in the labor market is based on decades-old research. Gravelle (2010) cites a study of this nature by David Birch in 1981, which found that firms with fewer than 100 employees created 80 percent of jobs over 1969–1976.<sup>7</sup> However, subsequent studies have questioned Birch’s methodology.<sup>8</sup> First, his findings included “establishment” rather than “firm” data, which is problematic because establishments are often outlets of larger firms (for instance, McDonald’s). Second, although some data may, on first glance, suggest that small businesses create a significant number of jobs, it turns out that industries dominated by small firms had been growing in the time period highlighted in the study, and the growth of the industries in which these firms operated could have occurred for separate reasons. Third, subsequent studies have pointed out that the firms that created jobs in excess of their share of the labor force were not necessarily distinct in that they were *small*, but rather that they were *new*. And while small and new firms create many new jobs, research has shown that the persistence of those jobs is in question, as many small new firms also fail within the first few years of existence.

A National Bureau of Economic Research study found no systematic relationship between firm size and growth after controlling for the age of the firm. While young new businesses contributed substantially to job creation, firm size had less to do with this than firm age, and young firms grew more rapidly than their mature counterparts. In fact, in comparing firms of the same age, the study found that small firms actually grew more slowly than large firms did.

The study additionally noted that oftentimes data sources used to examine the relationship between firm size and growth have limited or no information about firm age (Haltiwanger, Jarmin, and Miranda 2010).

A recent Congressional Budget Office (CBO) study on small firms came to similar conclusions, finding that net job growth is driven primarily by the creation of new small firms rather than the expansion of mature small firms. While almost all firms start small, the fact that many fail and many others are not designed to grow into large firms means that only a few small firms grow substantially and become large firms (CBO 2012a).

## The tax code and economic policy in general favor small businesses

While maintaining lower tax rates at the top would impact relatively few small businesses, these entities already receive benefits from the tax code. In fact, under current federal laws and regulations, small firms often receive more favorable treatment than large firms do (CBO 2012a).

For instance, under Section 179 of the tax code, small businesses can expense the cost of certain property in the year in which it is placed into service, rather than recover this cost over time through annual depreciation deductions. Under permanent law, the amount that firms can immediately expense is \$25,000 in qualifying investments, with the amount of qualifying investment eligible for the deduction decreasing dollar for dollar for amounts over \$200,000. The mechanics of Section 179 expensing are such that the benefits are targeted toward very small firms; the phase-out generally eliminates benefits for firms that exceed the phase-out limit. Since 2003, Section 179 expensing levels have been repeatedly increased. Congress has extended this expensing a number of times, each time on a temporary basis. More recently, the Small Business Jobs Act of 2010 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 set the maximum amount of expensing in 2012 at

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\$125,000, with the start of the phase-out at \$500,000 (inflation has increased these levels to \$139,000 and \$560,000, respectively). Parameters are scheduled to revert to \$25,000 and \$200,000 in 2013. The expansion of Section 179 is one of the main reasons that small businesses actually face zero or negative effective tax rates (Gale 2011).

That is not to say that this tax benefit necessarily provides a huge boost to the economy: The effect of Section 179 expensing on the long-term level or timing of investment actually remains ambiguous. Though the benefit does reduce the tax liability for small firms immediately and eliminates the need for these businesses to track capitalization and depreciation (Marron 2011), much of the tax benefit may be going toward investments that would have been undertaken even if longer term depreciation were required (TPC 2011b). Finally, because investment spending by firms generally decreases during economic downturns, boosting aggregate demand is likely more favorable to business than expanding provisions such as expensing. In their review of the literature on investment and employment tax incentives as economic stimulus, Hungerford and Gravelle (2010) found that these subsidies are “not as effective as desired in increasing economic activity, especially employment.” Similarly, Moody’s Analytics Chief Economist Mark Zandi estimates that temporary business tax cuts generate among the lowest “bang per buck” of any stimulus measure, with accelerated depreciation (or bonus depreciation) and loss carryback tax cuts—the two provisions most similar to Section 179 expensing—yielding multipliers of 0.29 and 0.25, respectively (Zandi 2011). Economic theory indicates that deficit-financed stimulus to boost aggregate demand would have the maximum short-term impact on demand and employment (Hungerford and Gravelle 2010).

Under the tax code, small businesses also benefit from favorable treatment of capital gains from individual investments. In 2011 for example, capital gains up to

either \$10 million or 10 times the taxpayer’s basis in the stock (whichever is larger) ensuing from new equity investments were exempt from income taxes if the stock was held more than five years (Marron 2011). Though not currently a permanent provision, President Obama has proposed making it so.

Additionally, the ability of businesses to organize as S corporations, sole proprietorships, partnerships, and limited liability companies allows them to avoid the corporate tax. C corporations can be subject to double taxation—a top rate of 35 percent on each marginal dollar of income, plus a tax on after-tax corporate earnings when they are distributed to the business owner(s) as dividends or share repurchases. If a business is able to avoid the corporate tax code, it faces only the individual income tax. This line of argument, however, overstates what corporations actually pay, because many C corporations disburse dividends or capital gains to foreign or tax-free entities, such as foundations and universities, and many large corporations pay little if anything in corporate taxes (McIntyre et al. 2011). The explosion of pass-through entities since the Tax Reform Act (TRA) of 1986 overwhelmingly reflects tax avoidance and arbitrage opportunities rather than a change in productive economic activity; by raising taxes on capital income and corporate income while lowering the top individual income tax rate, the TRA created an incentive to reorganize as a pass-through, not a fundamental change in the structure of U.S. economic activity. Further, CBO has estimated that the growth of businesses not subject to the corporate income tax has resulted in lower levels of federal revenues relative to what would be the case if businesses had to file as C corporations as opposed to S corporations or limited liability companies, and that limiting the use of pass-through taxation would increase federal revenues (though likely raise effective tax rates on businesses’ investments) (CBO 2012b).

Finally, in crafting the Affordable Care Act (ACA), the Obama administration went to lengths to ensure that small businesses would not be subject to new burdens.

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The ACA exempts all firms with fewer than 50 employees—which the administration identified as being 96 percent of all firms employing people in the United States—from any of the new employer responsibility requirements, and it made eligible for a tax credit firms that purchase health insurance and have fewer than 25 employees (CBO 2012a). These credits became available in 2010, and exist to improve access to affordable coverage for small firms, which over the last decade have had lower health insurance offer rates than larger firms (McMorrow et al. 2011). Small firms will also benefit from the introduction of the Small Business Health Options Program (SHOP) exchanges and other health insurance reforms that are intended to reduce administrative costs, improve risk-sharing, and promote transparency and competition (McMorrow, Blumberg, and Buettgens 2011).

The exemptions for small firms specified in the ACA, while important, do not necessarily break new ground; small firms are exempt in the tax code from many regulatory policies, for instance those prescribed by the Family and Medical Leave Act of 1993 (CBO 2012a).

## How can we really help small businesses?

If rising top marginal individual income tax rates should not particularly concern the vast majority of small businesses, what should? Addressing the depressed state of the overall economy is a good place to start. CBO found that job loss in the Great Recession affected small and medium-sized firms disproportionately compared with large firms. And although the instability of firms' sizes (sizes can change over time) led to some arbitrariness in how changes in employment were assigned to categories of firm size, CBO found the following: between December 2007 and December 2010 the total number of employees at firms with fewer than 50 workers fell by 7.1 percent, the number of employees at firms with between 50 and 499 workers fell by 8.1 percent, and the number

of employees at firms with more than 500 workers fell by 5.4 percent (CBO 2012a). The recession, according to their analysis, impacted smaller firms' employees disproportionately.

This is not surprising. As the study points out, small businesses have less access to credit than larger businesses and instead rely heavily on personal savings, funds from family and friends, credit cards, and vendor financing (Paglia 2011). As the economy enters a downturn, particularly if accompanied by a financial crisis, the main external source of credit that small businesses do have—bank loans—dries up as lenders more strictly assess the risk of small business investment during a recession and simultaneously shore up their own capitalization. For example, CBO found that the financial crisis of 2008–2009 affected access to capital for many small firms—the value of loans to small firms declined by 6.5 percent between June 2008 and June 2010—while at the same time owners became less able to fund small business activities using personal resources (CBO 2012a). It seems logical that, as CBO found, a recession the size and scope of the one that hit the U.S. economy from 2007 to 2009 would have a significant negative impact on small firms' ability to retain workers, as small firms are generally less insulated from business cycle downturns.

Addressing the demand shortfall is key to providing firms, both large and small, with the business they need to keep their doors open and their workers employed. Expansionary fiscal policy remains the most effective lever for boosting aggregate demand and restoring full employment. In fact, unemployment remains so high this far into the recovery because of the huge shock to private demand for goods and services resulting from the housing bubble's burst and its aftershocks, such as state and local government budget crises and austerity measures (Bivens 2011).

In other words, one of the best ways to boost small business fortunes is to employ fiscal policy to return the economy to good health. And it already has a proven track record: The American Recovery and Reinvestment

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Act—and to a lesser degree subsequent ad hoc stimulus provisions such as the payroll tax cut and expansion of emergency unemployment benefits—was responsible for saving or creating several million jobs. The extension of unemployment insurance, the reinstatement of the Making Work Pay refundable credit, infrastructure investments, state and local budget relief, and public works programs would all be effective in putting money into consumers’ pockets, thereby boosting demand for the goods and services that small businesses sell (Eisenbrey et al. 2011).

Beyond economic recovery, a stronger safety net could encourage and incentivize individuals to pursue the creation of small businesses by encouraging greater risk taking. When small firms are new, owners often take huge risks. They may leave safe jobs that provide pension and health benefits to their families; they may put a portion of their savings into fulfilling their entrepreneurial dream; or they may leverage themselves with large loans. Safety net protections—such as strong unemployment insurance and the ability to retain health insurance (e.g., COBRA benefits) in the face of possible unemployment—could go a long way in encouraging entrepreneurial activity and business ownership for those thinking about starting their own businesses (Bordoff, Deich, and Orszag 2006).

Conservative ideology that claims small businesses will be hurt by higher marginal tax rates at the top prioritizes helping firms that have already succeeded, not firms that are just starting out and that will likely fall below the top two tax brackets. New business owners would benefit more from knowing they were opening a business in an economy with strong enough demand for their goods and services to make it worth taking the risk, as well as in a society with a strong safety net available should they run into trouble.

## Conclusion

Claims that raising the top two marginal tax rates will stifle small business growth are unfounded, largely relying

on overly broad and misleading definitions of small businesses. Policies intended to support actual small (and new) businesses should focus on expansionary fiscal policy (for example, through fiscal stimulus) and a stronger social safety net.

If anything, reductions in the top tax rate have been associated with an increasing concentration of income at the top of the income distribution and not necessarily associated with productivity growth. Hungerford (2012) concludes that it would be “reasonable to assume that a tax rate change limited to a small group of taxpayers at the top of the income distribution would have a negligible effect on economic growth.” While many argue that tax increases at the top will hurt workers and the availability of jobs, pretax incomes have in fact historically been more equally distributed, and labor’s share of total income growth larger, when top tax rates have been higher (Hungerford 2012). Returning the top two rates to Clinton-era levels would not only leave most small businesses unaffected, it would also increase progressivity in the tax code and put the budget on a more fiscally sustainable path.

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## Endnotes

1. Boehner cites an Ernst & Young analysis that has been shown to have major methodological errors. In an analysis of the study, Citizens for Tax Justice reports that the Ernst & Young analysis assumes an “unrealistic drop in the labor supply by medium- and high-income earners due to higher tax rates.” The study also assumes that 100 percent of the revenue raised from adopting the policy would go toward increased spending, as opposed to deficit reduction (CTJ 2012).



2. As CBPP notes, President Obama's adjusted gross income included \$441,369 in book royalties that are reported as pass-through income, and Governor Romney's adjusted gross income included \$110,000 in author and speaking fees reported as pass-through income. Thus, both men would technically be included in the definition of small business owner (Huang and Marr 2012).
3. The Treasury study recognized that there is more than one way to reasonably define small businesses and their owners, and noted that the current definition is both too broad (because it includes both large firms and individuals that may not be engaged in "canonical business activities") and too narrow (because it excludes owners of small C corporations). To address these shortcomings, the authors of the study constructed narrower ways to define a business, a small business, and a small-business owner. They first used IRS data to look at the tax forms that could represent business activity and developed two tests to separate filers into business and non-business groups based on levels of "de minimis activity" (does the activity generate, or have the potential to generate, income that is non-negligible to the business owner(s)?) and "businesslike activity" (do the owners undertake actions that demonstrate "businesslike" activity?). They then subdivided the business group into small and other, setting the small-business threshold at \$10 million of income or deductions. Additionally, they used newly accessible tax data to separate reported small business income from other business income, in order to identify the relevant characteristics of small-business owners. To identify small-business owners, they used tax forms for Form 1040 Schedule C, E, and F filers, and newly accessible data from the IRS Compliance Data Warehouse for individuals reporting partnership and/or S corporation income. The findings from the Treasury study are reported in Tables 1–18 of the report (Treasury 2011).
4. The JCT analysis excludes taxpayers subject to the alternative minimum tax (AMT). It defines business income as income from sole proprietorships (Schedule C); rental real estate, royalties, partnerships, subchapter S corporations, estates and trusts, and real estate mortgage investment conduits (Schedule E); and farm income (Schedule F). It does not count income from interest, dividends, or capital gains that may pass through certain pass-through entities but is reported elsewhere on an individual's return as business income (JCT 2010).
5. Small businesses can be defined in a number of different ways; typically definitions are based on either number of employees or annual revenue. Small business standards are often applied on an industry-by-industry basis; the Small Business Association (SBA) sets standards by industry but also generally specifies a small business as having fewer than 500 employees and less than \$7 million in annual receipts (SBA 2012). Definitions can vary significantly, however; for example, a small business having fewer than 25 full-time-equivalent employees with average wages below \$50,000 qualifies for a tax credit under the Patient Protection and Affordable Care Act, while beginning in 2014 penalties will be levied on certain businesses with more than 50 employees that fail to offer health insurance (CBO 2012a). And in its recent analysis, CBO considered various firm-size thresholds, (as opposed to revenue) when analyzing large and small businesses; CBO stated, however, that "no uniform employee threshold has been adopted to define 'small,' either in federal legislation or in published research."
6. TPC identifies, for this analysis, the administration's upper-income tax proposals as the following: reinstating the 39.6 percent top rate and the 36 percent rate for married taxpayers with income over \$250,000 (\$200,000 for singles); reinstating the limitation on itemized deductions and the personal exemption phase-out for married taxpayers with income over \$250,000 (\$200,000 for singles); and imposing a 20 percent tax rate on capital gains and qualified dividends for taxpayers in the top two tax brackets (TPC 2010).
7. The Birch study is titled "Who Creates Jobs" and appeared in *Public Interest*, vol. 65, Fall 1981, pp. 3–14 (Gravelle 2010).
8. These include, for example, a study by Catherine Armington and Marjorie Odle, "Small Business: How Many Jobs?" which appeared in *The Brookings Review*, vol. 1, no. 2, Winter 1982, p. 104, and a study by Charles Brown, James Hamilton, and James Medoff, *Employers Large and Small*, Cambridge, Mass.: Harvard University Press, 1990 (Gravelle 2010).

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