THE IMPACT OF TAXATION ON SMALL BUSINESS

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The impact of the federal tax system on small business has been a matter of increasing interest and concern to many persons during the last few years. When the heavy spending during World War II forced Congress to increase very sharply federal taxes on both individual and corporate income, it was confidently expected that the high wartime rates would be reduced to more reasonable levels once hostilities had ended. Unfortunately, these expectations have been realized only to a very limited extent.

Although we were finally able to let the wartime tax on excess profits expire in 1954, we have not been able to go very far in reducing personal or corporate income taxes. In fact, the present fifty-two per cent rate on corporate profits in excess of $25,000 is a good deal higher than the forty per cent rate on ordinary profits that was in effect during World War II. Rates on personal income have been reduced slightly since the war; but most of the relief which individual taxpayers have received since then has taken other forms. Higher exemptions and new deductions and exclusions have reduced the percentage of personal income subject to taxation; and the option given to married couples to file joint returns so as to enjoy the advantages of "income-splitting" gave substantial tax relief to many of these taxpayers. In the field of business taxation, relief has taken the form of more liberal depreciation and depletion allowances, greater opportunities to give expense treatment to research and development outlays, and longer periods for averaging out profits and losses. Many of the changes made in federal business taxation between 1946 and 1954 were helpful to small business; but they still left small enterprises, as well as large ones, with tax burdens that were enormously greater than those which they had experienced before the war.

While this burden of federal taxation was known to be a repressant to all business, its impact was thought to have been especially severe on small businesses, mainly because they had little or no access to public markets for capital. Furthermore, despite the efforts that had been made to aid small business in the 1954 revenue revisions, it was argued that the law still contained provisions which unintentionally discriminated against small concerns. Attention was also called to some evidence that high federal taxes were discouraging the formation of new small enterprises and were impeding the growth of old ones.

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Those who believed that further steps should be taken to strengthen the small business sector of the economy received some support from the President's Cabinet Committee on Small Business, when it made its first progress report on August 7, 1956. This Committee, which had been appointed by the President at the end of May, and was headed by Dr. Arthur F. Burns, who was also the Chairman of the Council of Economic Advisers, agreed that small business had been hurt more by high taxes than had the larger firm and recommended several changes in the Revenue Code which it thought would be helpful. Still further support for tax relief for small business was offered by the Senate Small Business Committee after several months of hearings held in fourteen cities in different parts of the country during the fall of 1957. Most of the 293 witnesses who testified before the Committee were small businessmen with specific complaints to make regarding the incidence and effects of federal taxes. In the report which this Committee drafted early in 1958 for submission to the Senate, a number of ways were found in which it was thought that the Revenue Code, and those who were responsible for its administration, were unfairly burdening small business. The report also made a number of recommendations for removing this discrimination.

On the other hand, the position of small business in the American economy was appraised somewhat more optimistically in a number of studies contained in a report prepared by the Federal Reserve System, which was published in April 1958. Although these studies are not directly concerned with the impact of taxation on small business, they do suggest that in some respects the so-called plight of small business may be less serious than it has usually been pictured by small businessmen.

The tax problems of small business have, then, been very much in the public eye during the past few years. There has been much discussion of the needs of small concerns for tax relief, and careful consideration has been given to the various ways in which this might be given. Although the Government's budgetary situation during this period has not permitted the granting of any very substantial tax reductions either to big or to small business concerns, the changes in the tax law that were made in 1954, as well as those effected by the Small Business Tax Revision Act of 1958, were intended to be especially helpful to such firms. Yet, with all this discussion, and despite the apparent conviction with which Congress has moved to amend the Revenue Code in small business's behalf, the picture we get of the impact of federal taxes on small business is still not very clear. This is probably attributable in part to the fact that the small business sector of the economy is itself not very clearly defined, and to the fact that it embraces a great many different types of

1 CABINET COMMITTEE ON SMALL BUSINESS, PROGRESS REPORT (1956).
2 Id. at 2-4.
4 Id. at 8-24.
5 FEDERAL RESERVE SYSTEM, 85th Cong., 2d Sess., REPORT ON FINANCING SMALL BUSINESS pts. 1 and 2 (Comm. Print. 1958) [hereinafter cited as FEDERAL RESERVE REPORT].
enterprises upon which high taxes may have different impacts. As was pointed out in one of the Federal Reserve System studies, most small businesses are quite routine operations carried on within protected local markets; but some are pioneering ventures which, through the promotion of new products or the development of new processes, seek to enlarge their markets and to challenge the position of established firms.\(^7\) Furthermore, in many cases, the effects of taxation are qualitative rather than quantitative in character, which makes them more difficult to measure. Finally, it is sometimes difficult to isolate the impact of tax changes from the impact of other developments on small business; taxes are often blamed for events mainly attributable to other factors.

Although it is always difficult to solve a problem which has as many facets as this one appears to have, it should at least be possible to bring the main issues into somewhat clearer focus. From the standpoint of policy, the questions which we should like to be able to answer are reasonably clear. First, do high taxes bear more heavily on small concerns than they do on larger ones, even when they are imposed uniformly? And second, are there provisions in the present federal tax structure that intentionally or unintentionally discriminate against small business? Only if one or both of these questions can be answered in the affirmative would it seem possible to regard the tax problem of small business as being separate and distinct from that of business generally. These, then, are the questions on which we shall focus most of our attention in the balance of this paper. But before turning to them, a bit more will be said about small business itself and the role which it plays in the present-day economy.

I

SMALL BUSINESS AND ITS ROLE IN THE ECONOMY

We are told that there is no generally accepted definition of a “small” business, and that most persons who use the term do so without having in mind any specific definition of size.\(^8\) One can, of course, classify business firms by such quantitative criteria as the number of employees, total assets, or total sales, and then designate certain size classes as representing small business. For example, for purposes of financial aid from the Small Business Administration, a manufacturing firm is designated as “small” if it has fewer than 250 employees, while in the Federal Reserve business loan surveys, total assets have been used as the criterion for classifying borrowers as “small.” Yet, these designations are at best arbitrary, and they usually cannot be applied uniformly to firms in all industry groups. Qualitative criteria can also be used in attempting to define and identify a small business. It has been said, for example, that a small business is “one that is too small to float securities on the public market,” or “one that sells its goods and services in one community or

\(^7\) Garvey, Observations Based on the Background Studies, in *Federal Reserve Report* 1, 7-9.

to one customer," or is simply "one with a problem." Definitions such as these suggest that what is a "small" business depends to a considerable extent upon the type of analysis for which the definition is needed.

For the purpose of analyzing the impact of taxation on small business, qualitative criteria would appear to be more appropriate than quantitative ones. Tax disadvantages arise not because a concern has less than 100 employees or less than $250,000 in assets, but because it is dependent upon internal sources of funds to finance its growth, or because it is unable to exercise effective control over its prices and profits, or for some other reason of a similar nature. Qualitative criteria such as these cannot, of course, be applied very exactly, and they give us only a rough notion about the size of the universe with which we are concerned. On the other hand, it is possible that they can be equated fairly well with the more conventional definitions. Certainly, most of the concerns which would be classified as small by the Small Business Administration and by the Federal Reserve System for their respective purposes would also share such qualitative criteria of smallness as were mentioned above. This means that our universe comprises at least ninety-nine per cent of the firms operating in all industries, and at least ninety-three per cent of the firms engaged in manufacturing.9

But certainly not all of the 4,000,000 concerns with less than 100 employees are subject to tax disadvantages that are unlike those experienced by taxpayers generally. If our present tax structure does discriminate against small business, this discrimination would appear to be felt mainly by the minority of nonroutine businesses which have growth potential, and which have something to offer the larger firms that might like to absorb them through purchase or merger. Moreover, the generally accepted proposition that the existence of small business in this country is of vital importance because it makes the economy more efficient and progressive is one which can be strongly defended only if it applies to firms of a more dynamic character. These firms do play a vital role in the maintenance of active competition, and if high taxes or discriminatory provisions in the Revenue Code are weakening this type of competition, we shall be the losers. Hence, there is some reason to be concerned about the impact of taxation on small businesses of this type.

Some persons would go even further and argue that the importance of these pioneering firms is so great that the tax laws ought to discriminate positively in their favor. This, it is held, would compensate for certain nontax handicaps of small business. This proposal has, however, never been taken very seriously by those who shape the nation's tax policies. There has been no desire, either to subsidize inefficiency, or to penalize large concerns "that have come to the top through honest competition."10 Nor do many small businessmen desire special tax favors. Given a "fair break," they believe that they can hold their own against their larger

9 Of the 4,067,300 firms in operation on January 1, 1951, 4,030,400 had fewer than 100 employees. Of the 322,900 manufacturing concerns in operation on that date, 302,800 employed fewer than 100 employees. Survey of Current Business, May 1954, p. 23.
10 CABINET COMMITTEE ON SMALL BUSINESS, op. cit. supra note 1, at 4.
competitors. The question is, of course, whether they are getting a "fair break" under our present tax structure. Many of them clearly do not think so.

II

THE IMPACT OF HIGH TAXES ON SMALL BUSINESS

High federal taxes can affect the size and strength of the small business population in several ways. They can reduce the number of business births by discouraging those who might otherwise form new businesses. Second, they can slow down the rate at which small businesses are able to grow by making it more difficult for them to finance a rapid expansion. And third, they can weaken the desire and the ability of small concerns to survive as independent enterprises by making the gains from a sale or merger look more attractive than the income to be derived from continued operation. It can be argued from the experience of individual firms that high taxes have done all three of these things, but there are no data that indicate the extent of the impact in any of these directions.

A. Taxes and Business Births

During the years which have elapsed since the end of World War II, the number of new businesses formed has exceeded 300,000 every year. The peak years occurred right after the war when a great many men were coming out of the service; but, after setting a slower pace in 1948 and 1949, new business formations have held steady since that time. But the fact that the number of new business firms formed has remained high during the postwar years does not necessarily mean that high taxes have not been a deterrent to the establishment of new enterprises. To the extent that high personal income levies reduce the disposable income of persons in the middle and upper-income classes, they also tend to reduce the supply of equity funds available to finance new concerns; and, to the extent that they reduce the prospective returns from the purchase of shares in new firms, they tend to reduce the attractiveness of such shares for prospective investors. Investors in new small businesses ordinarily have to assume greater risks than do those who invest in the stocks of established firms; and these greater risks will not be assumed unless the expected returns are also proportionately greater. The higher taxes are on business income, the harder it is for new enterprises to meet this test. Furthermore, the small businesses to which outside investors are most likely to be attracted are those which are expected to grow rapidly; yet, it is known that high taxes can create serious financial problems for any rapidly growing business. High taxes are also likely to prove embarrassing to firms which have a weak control over their prices and profits. Since small firms usually have less effective control over their prices than large

1\textsuperscript{11} Markham, Trends in the Relative Importance of Small Business in Federal Reserve Report 197, 212.
ones do, they are less able to shift their taxes forward onto consumers, and this also tends to weaken their position in the equity capital market.\textsuperscript{12}

On the other hand, one should not exaggerate the adverse effects of high personal and corporate income taxes on the availability of equity capital for new enterprises. That small business has been able to attract large amounts of capital funds during the postwar years is shown by the number of new firms started during this period. One writer has estimated that between 1946 and 1956, over $10,000,000,000 was invested in new businesses, of which $6,000,000,000 was equity money.\textsuperscript{13} Almost all of this huge flow of investment funds is thought to have gone through informal channels. The view has also been expressed by at least one investment banker that high personal income taxes have not necessarily made it more difficult for new small businesses to raise outside equity capital.\textsuperscript{14} There has, it is said, been an increase in the number of persons of moderate means who have become interested in capital gains. Such persons are frequently attracted by the growth possibilities offered by new firms. Indeed, if there is one proposition on which virtually all students of small business finance are agreed, it is that the problem of raising equity capital for small concerns would be much more difficult if the preferential tax treatment currently accorded capital gains were to be abolished.\textsuperscript{15}

Although the capital gains prospect induces a good many investors to risk their savings in the shares of new business ventures, the fact that losses of small business stock could not, until this year, be used except to offset capital gains was a deterring consideration.\textsuperscript{16} Persons with diversified portfolios on which they were regularly realizing capital gains were not bothered by their inability to use these losses as an offset to their other income; but this limitation on loss offsets undoubtedly kept some persons from buying small business stocks.\textsuperscript{17} The owners of closely-held enterprises could, of course, have made certain of their tax offsets for losses by using the partnership rather than the corporate form of organization, although they might have hesitated to expose themselves in this way to an increase in their contingent liabilities.

As we shall note in a later section of this paper, the recently enacted Small Business Tax Revision Act of 1958 has gone a long way towards removing this deterrent to investment in small business corporations.\textsuperscript{18}

\textsuperscript{12} Id. at 542. This point was also made in the 1957 hearings of the Small Business Committee of the Senate. See Hearings Before the Senate Select Committee on Small Business on the Impact of Federal Taxation on Small Business, 85th Cong., 1st Sess. pt. 1, at 253 (1957) [hereinafter cited as Hearings].

\textsuperscript{13} Schweiger, Adequacy of Small Business Financing: Another View, in FEDERAL RESERVE REPORT 124, 130.

\textsuperscript{14} Id. at 145.

\textsuperscript{15} Id. at 543.

\textsuperscript{16} Id. at 544.

\textsuperscript{17} Individual taxpayers may use a net capital loss as an offset against ordinary income only up to the amount of $5,000, except as noted below.

\textsuperscript{18} Under the Small Business Tax Revision Act of 1958, 72 STAT. 1606 (codified in scattered sections of 26 U.S.C.), certain holders of small business stock are permitted to treat a loss from the sale of such stock as an ordinary loss.
B. Taxes and Business Growth

The Senate Small Business Committee was told repeatedly by the small businessmen who appeared before it in the fall of 1957 that the basic problem facing small business today is that of acquiring equity capital for necessary growth and expansion. Many witnesses complained about their inability to obtain the necessary funds for plant expansion or for additions to inventory. As one witness put it, "We have not been able to retain enough earnings in the business to hold our place in the industry, in the economy and among our competitors." Another stated: "Our greatest problem at this time is our inability to purchase the new machines required in our industry under current demands from the profits remaining after taxes. If we are to stay in business, these new machines are a must in order to meet rigid inspection of new products."

In addition to making it more difficult for small businesses to finance necessary growth, high taxes on business income are said to destroy the incentive for growth and efficiency. One businessman told the members of the Senate Committee: "Too many times a contemplated expansion program is dropped because it is just not worth the risk for possible after-tax gain." These statements are, of course, expressions of individual opinions, and the problems they depict are certainly not unique to small business. Nevertheless, the Senate Committee concluded, as did the President's Cabinet Committee on Small Business, that the high postwar taxes had been especially severe in the case of small concerns, largely because of their greater dependence on retained earnings.

Not all of the witnesses who appeared before the Senate Committee shared this concern over the effects of high taxes on the growth of small concerns. For example, Dean Lawrence C. Lockley, of the University of Southern California, argued that "the small business firm is under no disadvantage which requires preferential tax treatment from the standpoint of credit facilities." Legislation which gave small firms unusual tax advantages would, he thought, lead to a waste of public and private funds under normal conditions. It was his opinion that small business can expand and stand "on its own two feet without any help from the Government."

Several contributors to the Federal Reserve System's study of small business financing considered the adequacy of the supply of equity and loan funds for small enterprises. After examining the earnings records of small business firms since the war, and the savings practices of small businessmen, Irving Schweiger, of the University of Chicago, concluded that these data at least suggested that "a large percentage of small businessmen have all the equity funds they require plus considerable resources outside the business which can be tapped if desired." While most of the earnings data relating to small business suffer from distortion due to the tendency of

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19 Select Committee on Small Business of the Senate, supra note 3, at 5.
20 Id. at 4.
21 Ibid.
22 CABINET COMMITTEE ON SMALL BUSINESS, op. cit. supra note 1, at 2.
23 Hearings 85.
24 Hearings 141.
25 Schweiger, supra note 13, at 130.
small firms to understate income and overstate deductions, earnings before allowance for officers' compensation appear to have been quite high in relation to net worth. Statistical data bearing on this point are not abundant; but Schweiger did find evidence that small manufacturing had a high rate of earnings after taxes in the postwar period, and, in relation to net worth, one that was possibly higher than that of large manufacturing concerns. On the other hand, an examination of studies that have been made of family savings and net worth suggested to him that there is a real difference between the savings behavior of business and non-business groups, and that many businessmen have been able to save larger amounts than are needed to finance the expansion of their own firms.

As regards loan funds, there are no data showing the change in debt of all small businesses since the war, but the Securities and Exchange Commission and the Department of Commerce have jointly prepared estimates of the change in debt of nonfarm unincorporated businesses to banks and insurance companies, and to all other corporations. These estimates, which show a $34,000,000,000 increase in the outstanding debt of unincorporated firms to corporations, between 1946 and 1956, are viewed as not supporting the widely accepted view that the sources of credit for small business are becoming more limited. Schweiger also cites the 1955 Commerce Department survey of the external financing of small and medium-sized businesses, which found that fifty-six per cent of all firms had no desire for outside funds, and that approximately half of these desiring such funds attained the full amount desired.

Although he was unable to find much published data bearing on the point, Schweiger thought there were grounds for believing that small, rapidly expanding firms which are most in need of external equity funds were best able to attract them, both because the marginal rate of return on added equity investment of growth companies is high enough to enable them to pay an attractive price for such funds, and also because of the attractive opportunities they offer for capital gains. On the other hand, it was his opinion that closely-held firms which have exhausted their informal sources of funds, and which do not represent attractive "growth" situations, might have considerably more difficulty in expanding their equity capital.

A. D. H. Kaplan and Paul Banner, who also prepared a report on the adequacy of small-business financing for the Federal Reserve System's study, agreed that financing facilities for small business for short-term borrowing are reasonably adequate; but they found them becoming less so as the term for which the financing is desired lengthens. They also noted that the new invention or "exciting innovation" appears to stand a better chance of attracting outside funds than the profit possibilities opened up by less spectacular changes, even when the latter could add up to considerable growth for an established small enterprise. Small firms may, it seems,
reach points in their growth cycles where significant cost reductions can be achieved through specialized equipment and larger volume; and at such points, they are confronted with the choice of expanding, or of resigning themselves to remaining high-cost and low-volume producers. During these critical periods, when the small businessman must balance rapid growth and financial weakness against slower growth and possible loss of market, high taxes undoubtedly make it more difficult for him to elect to expand.

While it would appear to be well-established that high personal and corporate incomes taxes have made it more difficult for dynamic small businesses to finance their growth, the impact of taxation has clearly been more severe on some of these firms than on others. The small firm with bright prospects for very rapid growth has to go outside for new equity funds anyway; and a tax structure that stimulates inherently venturesome individuals to seek out growth situations of this kind may actually make it less difficult for firms of this type to secure the funds they need. But the rate of growth needed to make a small business an attractive investment is apparently quite high, and those small firms that cannot meet this test are forced to depend almost exclusively on retained earnings for additions to their equity capital. These latter firms are undoubtedly the ones which complain most about the burden of taxes on small business, although lower taxes would not appear to provide the complete answer to their financial problem. Even if they were permitted to retain a much higher percentage of their profits, many of the dynamic small businesses in this country would still need to attract some external capital. But to do this, as we have seen, they must be able to hold forth the promise of unusually rapid growth. To the extent, therefore, that the growth of small business is being retarded by an inadequate supply of equity funds, only a part of the blame for this can be laid to high taxes.

C. High Taxes and Small Business Survival

Although some 300,000 new businesses are started in this country each year, almost as large a number are discontinued. The bulk of the firms in both categories are, of course, small enterprises. Since 1948, the annual net increase in the number of businesses in operation has averaged about 41,000 firms, with both the number of business births and the number of business deaths rising moderately.

Businesses may be discontinued for a number of reasons. Some discontinuances are forced by failure, although the number of failures appears to account for only a small fraction of all business deaths over the years. In other cases, firms may

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32 Id. at 121.
33 Those interviewed in connection with the Federal Reserve System's survey of opinion among persons involved in supplying external equity capital to small business were generally of the opinion that the prospect of a 20% annual appreciation on their investment was needed to induce investors to put equity funds into small enterprises. Brown, Miller, Ritter, & Robinson, Availability and Cost of External Equity Capital for Small Business Ventures, in id. 525, 536.
34 Markham, supra note 11, at 211.
35 Id. at 213; Kaplan & Banner, supra note 31, at 117.
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voluntarily wind up their affairs without involving creditors in losses; and in still others the discontinuance may be the result of an absorption or merger.

High taxes do not appear to contribute significantly to small business failures, the blame for which has usually been placed on such personal factors as incompetence, inexperience, lack of judgment, and the like. On the other hand, some writers argue that a basic reason for the high turnover in the new business population is undercapitalization. Since the new business that fails within a year or two after its formation rarely has earned any profit or incurred any tax liability, high taxes cannot be directly blamed for its inability to accumulate capital out of earnings; but the impact of high taxes on the personal savings of the owners of the new business could, of course, have contributed to the original undercapitalization of the firm.

The present federal tax structure is, however, known to have had a very considerable influence on the extent and character of the merger activity that has taken place in this country since 1940. In an intensive study that was made at the Harvard Business School a few years ago of the effects of taxes on mergers, it was found that certain features of the tax structure were exerting strong pressures on the owners of closely-held businesses to sell out or to merge with other companies. Decisions to sell closely-held businesses were found to be prompted mainly by the anticipation of liquidity problems under the estate tax in the event of the owner's death, and to be reinforced by the desire of the owners of successful firms to take out their profits without having them taxed at ordinary income tax rates.

At that time, it appeared that liquidity problems were likely to arise under the estate tax whenever a substantial block of the stock of a closely-held company was owned by a wealthy individual and constituted a major fraction of his investment portfolio. If, at the same time, there was no market, or only a very thin market, for such stock, estate tax liabilities could force its sale under unfavorable conditions, to the detriment of the business itself as well as to the heirs of the former owner. In addition to these liquidity considerations, there was considerable uncertainty as to the value which the Treasury would place on the shares of such companies for estate tax purposes. The desire to avoid this uncertainty was believed to have had some influence on decisions to sell out, although probably not a very great one in most cases.

It was also apparent that the large differential which wealthy individuals find between high personal income taxes and the much lower levies on capital gains has reinforced the impact of the estate tax on the owners of profitable closely-held busi-

Kaplan & Banner, supra note 31, at 117.


Some relief from these problems was afforded by certain provisions of the Small Business Tax Revision Act of 1958, 72 Stat. 1666 (codified in scattered sections of 26 U.S.C.).
nesses. While such persons have been understandably reluctant to withdraw accumulated earnings in the form of cash dividends that, since 1954, have been taxable at rates as high as ninety-one per cent, they have clearly been attracted by the opportunity afforded them under the present tax law to take their profits out in the form of capital gains from the sale of the business, which are taxable at a maximum rate of twenty-five per cent.

Even when the age of the owner of a small closely-held business has been so low that he has had little reason to be concerned over the imminence of heavy estate taxes, the income tax structure by itself appears to have encouraged the sale of small growing businesses in which the owners have built up substantial equities which might be lost if future competition became more keen, or if general business conditions worsened. In such cases, the knowledge that gains realized from the sale of the business will be taxed at the low capital gains rate has frequently influenced the owner's decision to cash in on his profits at once by selling his business to another company, rather than continue to operate it himself as a separate business entity.

Still another situation where the federal tax structure has been found to encourage the discontinuance of small businesses through a sale or merger is the one in which a successful closely-held firm has earnings substantially greater than its needs for additional capital. In such cases, further accumulations of earnings might risk the imposition of the old section 102 penalty tax on corporations improperly accumulating surplus. On the other hand, the owners of these concerns may not wish to receive larger dividends on which they would have to pay very heavy personal income taxes. In situations of this kind, the outright sale of the business has been an attractive way of avoiding both of these undesirable tax consequences. Alternatively, mergers have been effected with larger companies much less likely to be subject to the penalty tax on unreasonable retentions.

Views similar to those encountered by the men who made the Harvard Business School survey were expressed at the hearings of the Senate Small Business Committee, in 1957. One California businessman told the committee that the only way in which small business owners can fully reap the benefits of their efforts over past years in building a business is by selling it and taking the money received at the capital gains rate. He said that one man had told him "that at the present rate at which he was adding surplus to his small company's account, it would take him ten years to obtain the amount that he could obtain by selling out now at capital-gain rates." Other witnesses testified to the effects of the estate tax in fostering economic concentration.

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41 Id. at 696.
42 Hearings 160.
43 Select Committee on Small Business of the Senate, supra note 3, at 12.
Thus, it would appear to be well established that high federal taxes on income and estates have made it difficult to maintain the continuity of many small closely-held businesses in recent years. When the owner-manager of such a firm wishes to retire, he can usually minimize his tax liabilities and increase the liquidity of his estate by selling out to, or exchanging shares with, another larger corporation. If, on the other hand, he were to transfer ownership to persons who would continue to operate the business as an independent enterprise, he would ordinarily have to assume greater risks and incur heavier tax liabilities. And when the owner-manager of a closely-held small business dies before divesting himself of his interests in it, the pressing need for cash to pay his estate taxes has, again, given large corporations an advantage over other prospective purchasers. As will be noted later in this discussion, post-1950 amendments of the Internal Revenue Code have softened the impact of the estate tax on small businesses to some extent. But while these changes have made it easier for family corporations to maintain an independent existence following the death of a major owner, they have done little to promote the continuity of small enterprises as independent units in those situations where the owners may desire to relinquish ownership before death.

III

The Impact of Specific Tax Provisions and Practices on Small Business

The tax complaints of small businessmen have not been directed exclusively at the magnitude of their over-all tax burdens and the effects which they believe these burdens are having on the ability of small concerns to grow and to survive. Small businessmen have also complained that certain provisions of the Revenue Code; and certain practices of the Revenue Service, discriminate against small firms. And they have argued that the increasing complexity of the Revenue Code, as well as the uncertainties that surround its administration, impose extra and discriminatory burdens on these firms. Complaints such as these deserve careful consideration. For although many persons will not agree that our tax laws should discriminate in favor of small business, few if any would contend that the laws should discriminate against the small firm. What, then, are the areas in which discrimination against small business is said to occur?

One section of the Code which is said to bear especially heavily on small business is section 531 (formerly section 102) which imposes a penalty tax on unreasonable accumulations of surplus. Although, since 1954, the burden of proof as to the reasonableness of surplus accumulations has fallen on the Government rather than the taxpayer, and although it is generally recognized that the effect of the provision today is almost wholly psychological, its presence on the statute books still is said to be an additional burden on small concerns that is not thrust on larger publicly-owned corporations.

If there is any merit in this complaint, it would appear to lie in the fact that small business firms are subject to a tax uncertainty that larger concerns can safely dis-
regard. The object of the accumulated earnings tax is, of course, to discourage the owners of certain closely-held companies from doing something that the owners of large public companies cannot possibly do—namely, controlling the flow of corporate dividends with a view to avoiding personal income taxes. Few corporations have ever been made to pay this penalty tax, and the question of possible liability under it has been raised by the Revenue Service only in a relatively small number of cases. Nevertheless, this is clearly a provision which must be retained in the Revenue Code in the interests of over-all tax equity, even though it does affect only small closely-held companies, most of which have wholly legitimate reasons for retaining income. The most that can be done to ease the psychological impact of this levy on innocent firms is, perhaps, to increase, as Congress recently did, the amount of the minimum accumulated earnings credit.\textsuperscript{43}

A second and more important area of possible discrimination against small business has been found in the provisions relating to depreciation allowances. Prior to 1954, the complaints of small businessmen were directed mainly at the manner in which the depreciation provisions of the Revenue Code were administered; but since that time, they have had a complaint against the statutes as well. Up until 1954, businesses were permitted to write off the cost of capital improvements in accordance with rules laid down by the Internal Revenue Service in Bulletin F, which, among other things, indicated the length of time over which assets of various types should be written off under normal conditions. Any taxpayer wishing to spread his depreciation allowances over a shorter period had to assume the burden of proof; and it is not unlikely that large firms were more successful in securing exceptions than were small ones. In any case, small businessmen have long been critical of the administrative rulings which prevented them from accumulating, in the form of depreciation reserves, as much working capital as they thought they were entitled to.

The Internal Revenue Code of 1954 did not change basically the method of determining the normal useful lives of depreciable assets, but it did give taxpayers the option of using a liberal declining-balance formula in place of the traditional straight-line one in determining the amount of depreciation that could be taken in any one year. Under the new formula, it was possible to write off roughly two-thirds of the cost of an asset over the first half of its useful life, whereas under the old one, the same amount was written off each year. With depreciation charges thus accelerated, and income taxes correspondingly reduced, the new formula was especially helpful to growing firms that were continuously adding to their stock of depreciable assets. The 1954 law, however, allowed the declining-balance formula to be used only in the case of new assets. This meant that those firms which bought used machines or second-hand equipment could not enjoy the benefits of accelerated depreciation. And since the firms which buy used rather than new capital assets are

\textsuperscript{43}See p. 115 infra.
typically small firms, this limitation was held to be a new form of discrimination against small business.\textsuperscript{44}

There would appear to be some merit in this complaint, although the arguments in support of the limitation are stronger than most persons have realized. From the standpoint of the theory of the depreciation allowance, it can be argued that the value-erosion pattern that is implicit in the declining-balance formula is not as appropriate for used assets as it is for new ones. Records show that the resale prices of new machines fall quite sharply during the early years of their use, and decline more gradually thereafter. But this is not believed to be the case with used machines. Accordingly, to allow accelerated depreciation with respect to second-hand equipment would be to allow the owners of these assets to understate their income for tax purposes, and so enjoy a tax subsidy to which they were not entitled. Furthermore, from an administrative standpoint, allowance of accelerated depreciation on used assets would present a difficult policing problem. Depreciation charges reduce ordinary income and, at the same time, reduce the basis of the asset for purposes of determining gain or loss from its sale. Whenever depreciation charges exceed the actual decline in the value of a capital asset, its basis will tend to be lower than its market value; and if the asset is sold, its owner will realize a capital gain. If capital gains were taxed at the same rates as ordinary income, there would be no advantage in selling overdepreciated assets, since the tax on the gain would be the same as the tax saving on the excess depreciation. But in a country such as ours, where capital gains are taxed at a rate only half as high as the rate on ordinary corporate profits, a law which permitted used assets to be overdepreciated would open up extensive opportunities for tax avoidance.\textsuperscript{45}

The major argument against the limitation is that it reduces, to some extent, the good effects which more liberal depreciation allowances were expected to have on plant improvement and modernization. Any measure that would increase the demand for second-hand equipment will ordinarily also increase the demand for new equipment, since the purchasers of the new machines expect to cover a part of their costs out of the proceeds they receive from the sale of the machines they are discarding. Thus, if the allowance of accelerated depreciation on old used equipment would increase the demand for such assets, this would make the allowance of similar treatment on new assets even more effective. As we shall see below, Congress was unwilling to extend the declining-balance formula to cover used as well as new assets, in its 1958 tax revisions, but it did offer a substitute in the form of an additional first-year depreciation allowance for small business.\textsuperscript{46}

A third area of alleged discrimination against small business has been found in the special tax advantages accorded to those persons who are eligible for membership

\textsuperscript{44} Select Committee on Small Business of the Senate, supra note 3, at 12.

\textsuperscript{45} To prevent such tax avoidance in the case of "emergency" assets eligible for amortization over a 60-month period, taxpayers are required to report as ordinary income any gains from the sale of such assets to the extent that they reflect amortization taken in excess of normal depreciation.

\textsuperscript{46} See p. 11 infra.
in pension, profit-sharing, or stock bonus plans, as provided for by section 401 of the Internal Revenue Code of 1954. Since it is not easy for a small corporation to set up and maintain plans that will qualify for these special benefits, the small businessman believes he has grounds for complaint, since this puts him at a considerable disadvantage in competing with larger firms for employees. He finds that he must spend more than the large firm to give his employees compensation that is equivalent to the salary and retirement benefits they could get from the competing concern. Moreover, in the case of the proprietorship, the individual proprietor cannot qualify as an "employee," and so cannot get favorable treatment for himself, even though he could manage to set up a pension plan for his employees.47

This would appear to be another case where an attempt on the part of Congress to ease the burden of high personal income tax rates has had an uneven impact. In effect, Congress has made it possible for the employees of certain corporations and other concerns with approved pension plans to shift a portion of their current income to their years of retirement. Other taxpayers, including self-employed professional men and small businessmen, would like to have the same privilege, and they have proposed legislation which would allow a deduction for contributions to voluntary restricted retirement funds.48 Despite the strong support which this proposal has received from many congressmen, it has not been able to win approval in the Senate. Although its enactment has been supported as a small business relief measure, the number of small businessmen who would benefit from it would probably not be very great.

A great many of the small businessmen who appeared before the Senate Small Business Committee in 1957, had a more general complaint to make concerning the discriminatory features of the federal tax structure. They spoke feelingly of the difficulties encountered by the small businessman in attempting to comply with the tax laws and regulations as issued by the Treasury Department. As one witness put it:49

When you dare not make a business move without your tax accountant at your right hand and your attorney at your left; when the independent American businessman is so entangled in rules, regulations and red tape, so that a good portion of his time and money must be spent in clarifying confusion, gentlemen, that is a tax too. And small business finds it a grievous one.

Frequent changes in tax regulations, as well as tardiness in their issuance, have also been the source of considerable complaint.50 These practices, along with inconsistent

47 Select Committee on Small Business of the Senate, supra note 3, at 10.
48 These groups succeeded in getting House approval for the Self-Employed Individuals' Retirement Act of 1958, otherwise known as the Jenkins-Keogh bill; but this bill was not reported out by the Finance Committee of the Senate.
49 Hearings 5.
50 One instance of tardiness in the issuance of regulations affecting small business is found in the case of certain unincorporated business enterprises that were given the option of being taxed as corporations by the Internal Revenue Code of 1954. Four years later, the regulations governing the making of this election had still not been issued.
interpretations of the Internal Revenue Code resulting from nonacquiescence of the Treasury in judicial rulings, have been said to work special hardships on small business. While complaints of this sort are not easy to evaluate, there can be no doubt that a tax structure as complex as the present one imposes very heavy compliance burdens on small enterprises.

IV

Reducing the Tax Handicaps of Small Business

Most of the tax handicaps to which small business is said to be subject could be removed quite easily if this country were in a position to make a substantial reduction in taxes. It is mainly because taxes are so high that small business finds itself at a disadvantage in its competition with larger firms. If all businesses were taxed less heavily, the small firms would find themselves in a relatively stronger position financially, because they would be able to retain a larger percentage of their profits. Furthermore, if tax rates were lower, those provisions of the Revenue Code which tend to discriminate against small business would have a less severe impact. Unfortunately, Congress has not yet been able to allow the scheduled five-point reduction in the corporations income tax to go into effect. Therefore, for the relief of small business, it has had to confine itself to measures which are not likely to have significant revenue effects. Resort to such measures has, however, been a rather recent development.

During the early postwar years, when the prospects for lower tax rates were quite bright, proposals to create special tax privileges for small business were not widely supported. The Committee for Economic Development, for example, while recognizing that there were provisions in the tax system which were bearing with special severity on small business, did not believe that it was in the public interest "to invoke discriminatory taxation in favor of small business for the purpose of forcing funds into particular channels." Instead, it recommended tax reductions and reforms that would be beneficial to all enterprises, and that would be especially valuable in removing handicaps that bear most heavily on small business. Reliance on general tax measures, it was thought, was likely to involve fewer economic, equity and administrative problems than would the use of special small business measures.

With the outbreak of the Korean crisis in 1950, the prospects for substantial general tax cuts became dimmer; and it was not until 1954 that steps could be taken to give business some measure of relief from wartime tax burdens. In that year, the excess profits tax was allowed finally to expire, and new legislation provided (1) a longer loss "carry-back," (2) some relief to shareholders from "double-taxation," (3) more liberal depreciation allowances, (4) greater opportunities to expense research and development costs, and (5) some relief from the penalty tax on accumulated

62 Hearings 193-94.
64 U.S. Division of Tax Research, Treasury Dep't, Taxation of Small Business 4 (1947).
Although none of these changes in the Revenue Code were strictly small business measures, the last two were probably more helpful to small concerns than they were to large ones. On the other hand, these 1954 revisions did little to help the new small business without sufficient income to be able to take advantage of them.56

When the President’s Cabinet Committee on Small Business made its first progress report in August 1956, the budget outlook was believed to be sufficiently good to warrant a cut in the corporate rate. Accordingly, the Committee’s first recommendation was for a reduction in the rate applicable to the first $25,000 of income from thirty to twenty per cent. This action, it was stated, would “help the smaller firms to retain earnings for financing expansion, or would give them some advantage in pricing.”57 The Committee also thought that the proposed rate reduction would encourage the formation of new businesses. In addition to this rate cut, the Committee recommended: (1) that businesses be given the right to utilize, for purchase of used property not exceeding $50,000 in any one year, the declining-balance formulas that were made available to purchasers of new property, in 1954; (2) that corporations with a relatively small number of stockholders be given the option of being taxed as if they were partnerships; and (3) that the taxpayer be given the option of paying the estate tax over a period of up to ten years in cases where the estate consists largely of investments in closely-held concerns.58 The Committee thought that the first of these proposals would improve the financial position and outlook of many small businesses, that the second would particularly benefit small concerns having stockholders with very modest incomes, and that the third would reduce the pressure of heavy estate taxes on closely-held corporations, and so reduce the number of mergers and dissolutions.

President Eisenhower endorsed the last three of these proposals in a letter which he wrote to the Chairman of the Ways and Means Committee of the House of Representatives on July 15, 1957. In view of the less favorable budget outlook at that time, he was unable to recommend a cut in the corporate tax rate; but he did suggest that an ordinary loss deduction, up to some maximum amount, instead of a capital loss deduction, might be allowed on original investments in the stock of small companies.59 The purpose of this new proposal was to stimulate venture capital investment by offering investors greater and more certain tax advantages from any losses they might sustain on such investments.

The Senate Small Business Committee went somewhat further than the President in the recommendations which it made for small business tax revision in January 1958.60 While also favoring the partnership option for closely-held corporations,

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55 Brown, Miller, Ritter, & Robinson, supra note 33, at 541 n. 13.
56 Cabinet Committee on Small Business, op. cit. supra note 1, at 4.
57 Id. at 4-5.
59 Select Committee on Small Business of the Senate, supra note 3, at 8-21.
accelerated depreciation for a limited amount of newly-acquired used assets, and the spreading of estate tax payments in the case of estates having substantial assets tied up in closely-held businesses, the Senate Committee made a number of new recommendations. The one which it thought would accomplish more than any other single tax adjustment toward permitting small business to grow and prosper was a deduction for income tax purposes for any business which increased its investment in inventory or depreciable assets out of income. This deduction was to be graduated so as to require the taxpayers to assume full responsibility for a portion of the expansion, and was to be limited to a maximum annual allowance of $10,000 for a firm investing $30,000 or more in eligible assets.\(^6\) The Committee also recommended a retirement deduction which would relieve any taxpayer of taxes on reasonable sums set aside for his own retirement, an increase in the minimum accumulated earnings credit to relieve small business "from the more onerous restrictions imposed by the accumulated earnings tax,"\(^1\) and certain changes in administrative policy which it thought would be helpful to small business.\(^2\)

With these and other small business tax recommendations before it, the Ways and Means Committee began, early in 1958, to draft a small business tax revision bill. This bill, which was submitted to the House on July 16th, called for five specific revisions in the Revenue Code.\(^3\) Following the suggestion contained in the President's July 1957 letter, the bill provided ordinary loss treatment (up to $25,000 a year, or $50,000 a year in the case of a husband and wife filing a joint return) where the original holder of small business stock might sell it at a loss. The bill also raised the accumulated earnings credit from $6,000 to $10,000, thereby increasing the amounts which a business could accumulate over a period of years without the possibility of the imposition of any accumulated earnings tax. And, in line with the recommendations made by both the President's Cabinet Committee and the Senate Small Business Committee, it provided that where the estate of a decedent consisted largely of an interest in a closely-held business, the estate might have up to ten years for payment of the federal estate tax. But instead of granting accelerated depreciation for newly-acquired used assets, as had been recommended by these committees, the bill provided for an initial twenty per cent write-off for all tangible personal property, whether new or old, with the total amount of acquisitions eligible for this treatment limited to $10,000 a year, or $20,000 a year in the case of a husband and wife filing a joint return. Finally, the bill extended the net operating loss carryback from two to three years.

Following its approval by the House of Representatives, the Small Business Tax Revision Act of 1958 was sent to the Senate, where it was referred to the Committee on Finance. When this Committee delayed reporting out this bill, it was offered as a Senate floor amendment to the Technical Amendments Act of 1958, and was

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\(^6\) Id. at 9.  
\(^7\) Id. at 17.  
\(^8\) Id. at 18-21.  

ultimately approved as title two of that bill. The Technical Amendments Act itself contained a number of provisions which were intended to be helpful to small business. One of these granted certain small-business corporations the option of being taxed as partnerships, while another provided that investment companies established under the Small Business Investment Act of 1958 should be allowed an ordinary loss deduction, rather than a capital loss deduction, on losses realized on any of the convertible debentures they might acquire in supplying long-term equity-type capital to small business concerns. Furthermore, persons subscribing to the stock of these investment companies were allowed an ordinary loss deduction on losses arising from the worthlessness, or from the sale, of such stock. Finally, the investment companies themselves were granted a deduction for 100 per cent of the dividends received from taxable domestic corporations, rather than the usual eighty-five per cent. Thus, after some ten years of repeated urging, Congress has given small business some of the tax relief for which it has been asking.

V

Conclusions

In drafting this country's tax laws, Congress has never had any intention of discriminating against small business. Indeed, for many years, it has favored small corporations by moderately graduating the rates at which corporate income has been taxed. Nevertheless, there is some evidence that the high taxes which have been imposed on most businesses during and since the last war have hurt many of the smaller concerns more severely than they have the larger ones. Unless it has been expected to have spectacular growth, the small dynamic business has been handicapped by its inability to retain and reinvest its own earnings. At the same time, high personal income taxes have dried up many of the sources from which small concerns used to draw their outside equity funds. While the appreciation-minded investors are still willing to finance ventures where growth prospects are extraordinarily bright, they appear to be less interested in situations where only moderate rates of growth can be promised. In the second place, high taxes appear to have given considerable impetus to the postwar merger movement which has swallowed up so many small growing concerns. In the face of very high income and estate taxes, the owners of these concerns have found in mergers with larger corporations opportunities both to increase the liquidity of their estates and to realize in

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64 72 STAT. 1666 (codified in scattered sections of 26 U.S.C.).
65 The partnership option was intended to make it possible for small corporations which are essentially partnerships to enjoy the corporate form of organization without being made subject to certain tax disadvantages of the corporation. In those cases where small, closely-held corporations elect to be taxed as partnerships, the stockholders will be able to escape the double tax on distributed profits and will be able to deduct from their own taxable personal income their pro rata share of any losses which the corporations may sustain. Small businesses able to offer prospective stockholders these advantages should be able to attract capital funds somewhat more easily than they could have done under prior law.
the form of capital gains income which had been reinvested in the business over the years.

In addition to being handicapped by high taxes, small growing concerns, and especially those which are relatively young enterprises, have probably not benefited as much as their larger competitors from certain wartime and postwar revisions in the tax structure, which were designed to help business generally. It appears that many such firms have been unable to take advantage of the favorable tax treatment accorded approved pension plans, of the right to accelerate depreciation charges on new assets, or of the right to expense certain research and development outlays. Finally, there would appear to be some merit in the complaint that the increasing complexity of the federal tax laws, and of the regulations of the Internal Revenue Service are in themselves an added tax burden which the smaller concerns feel more severely than do the larger ones.

The 1958 revisions in the Revenue Code should help in a small way to soften the impact of high taxes on the growth of small firms. By giving investors the tax benefits of ordinary losses when their investments in small business turn out badly, the risks they assume in making such investments will be somewhat reduced, and their willingness to invest accordingly increased. The granting of an initial twenty per cent depreciation allowance will enable profitable small businesses to recover more rapidly their outlays on new assets, and so make it possible for them to finance a somewhat larger part of their equity capital needs from internal sources. Extending the loss carryback period and permitting the spreading of estate tax payments should ease the liquidity problems of loss corporations and of estates in which a small business accounts for the bulk of the decedent’s assets. But none of these changes in the law has significantly lifted the present-day tax burdens of small business. These cannot be lightened until we are in a position to make a general reduction in tax rates.