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Small Businesses and Marginal Income Tax Rates

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A common claim in recent tax policy debates is that raising or cutting the highest income tax rates would disproportionately affect small businesses. The table below defines small businesses owners broadly to include anyone who has any entry (positive or negative) on Schedule C (self-employment income), Schedule E (income from rents, royalties, partnerships, limited liability companies, and S corporations) or Schedule F (farm income). This is the same definition used by the Treasury Department (Department of Treasury; "State-By-State Breakdown of the Combined Effects of EGTRRA and JGTRRA," April 1, 2004). The table shows several facts.

First, few small business owners face the highest marginal income tax rates. Less than 9 percent of returns with small business income are in tax brackets

of 28 percent and above, less than 3 percent face rates of 33 percent and above, and only 1.3 percent are in the top bracket. Roughly 97 percent of small businesses would not be affected at all by increases in the top two tax rates. More than two-thirds of all returns with small business income are in the 15 percent or lower tax bracket, and 88 percent face rates of 25 percent or below.

Second, business income is not the dominant form of income in any positive tax bracket. It totals one-third of income in the top bracket, less than one-quarter in the second bracket, and smaller shares at every other positive tax rate. (The high share in the zero bracket occurs because business losses are substantial, but their absolute value is used to determine the ratio of business income to AGI.)

Third, although many returns in the top two brackets have at least some business income, few returns have most of their income from small businesses. For only about one-third of households in the top bracket and one-fifth in the second bracket is more than half of their income from business income.

Distribution of Tax Units With Small Business Income Using AGI, ¹ 2004							
Statutory Income Tax Bracket	Distribution of All Tax Units (percent)	Distribution of Tax Units With Small Business Income	Percent of Returns With Small Business Income				Percent of AGI Due to Small Business
			Any Business Income	>10% AGI	>25% AGI	>50% AGI	
0%	30.0	21.8	16.7	14.8	13.4	11.6	69.0
10%	15.3	13.5	20.1	15.0	10.9	7.3	10.8
15%	33.6	33.1	22.6	11.4	6.5	3.6	6.2
25%	15.9	20.1	28.9	11.3	6.2	3.6	6.2
28%	2.3	4.2	41.3	20.1	13.7	9.2	12.1
33%	0.5	1.3	59.1	37.3	28.8	20.3	23.1
35%	0.4	1.3	78.1	54.3	46.0	34.8	33.6
AMT Brackets							
26%	1.2	2.6	51.2	25.2	16.2	10.0	13.1
28%	0.7	2.0	62.2	33.2	23.9	15.9	19.3
All	100.0	100.0	22.9	13.8	9.9	7.1	12.9

Source: Urban-Brookings Tax Policy Center Microsimulation Model.
¹The absolute values of schedule C, E, and F income are summed to obtain total small business income.



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