ECONOMIC ANALYSIS

New Research Weakens Case For Small Business Tax Relief

By Martin A. Sullivan — martysullivan@comcast.net

Next to support for the troops, nothing is more sacrosanct on Capitol Hill than support for small business. As community leaders and campaign contributors, small business owners have always been near and dear to the hearts of politicians in both parties. The recession has only heightened their stature. There were no bailouts for small businesses. And since 2008 the stubborn persistence of unemployment has elevated their position even more. That's largely because the unchallenged conventional economic wisdom is that small businesses are the source of most job creation.

The National Federation of Independent Business states on its website: "Small business has created about two of every three net new jobs in the United States since at least the early 1970s." And on its website, the Small Business Administration claims, "Small firms accounted for 65 percent (or 9.8 million) of the 15 million net new jobs created between 1993 and 2009." These claims are endlessly repeated on television and in print. And both political parties are perfectly happy to leave them unchallenged. But two new strands of academic research are quietly shredding the idea that policies to support small businesses hold the key to job creation.

Creative Destruction

Economists John Haltiwanger, Ron Jarmin, and Javier Miranda have examined the complex dynamics of U.S. employment growth and the job creation and job destruction that occur as companies are being created and going out of business. (Jarmin and Miranda are currently with the U.S. Census Bureau. Haltiwanger, now a professor at the University of Maryland, is a former chief economist at the bureau.) With new data that allow them to look at firms' ages, the three observe that most start-up firms exhibit an "up or out dynamic." Young firms are likely to grow much more rapidly than mature firms. However, young firms are also much more likely to go out of business than mature firms. Overall, young firms' job creation and destruction are far more volatile than mature firms'. It is this creative destruction that keeps the economy moving toward higher productivity.

That volatility creates all sorts of potential pitfalls for researchers. Most importantly, it has allowed perpetuation of the myth that promotion of small business is synonymous with job creation. Using new data from the Census Bureau, Haltiwanger, Jarmin, and Miranda avoid the common statistical problems that create this illusion. They find that it is the youth of small firms, not their size per se, that is creating jobs. In fact, their findings show that mature small firms have a negative effect on job creation. "A natural conclusion from our findings on the role of firm size and age is that policies that target businesses of a certain size, while ignoring the role of age [of the firm], will likely have limited success in improving net job creation," the authors write.

That is bad news for Republicans who use small businesses as the poster children for prevention of high-bracket rate increases. Even if tax cuts for high-bracket taxpayers could be targeted to small businesses, which they can't (see *Tax Notes*, Sept. 5, 2011, p. 979, *Doc 2011-18511*, or *2011 TNT 172-2*), they would still be ineffective because they are not targeted to the subset of small businesses that actually are responsible for creating jobs. Put differently, tax relief for taxpayers in upper-income brackets is unlikely to help job creators, because these provisions provide tax relief to high-bracket non-employer income, and much of the employer income that does benefit goes to mature firms that don't play a significant role in job creation.

Not So Entrepreneurial After All

In another recent paper from the National Bureau of Economic Research, University of Chicago economists Erik Hurst and Benjamin Pugsley analyze a new data set and find that most small businesses are not the catalysts of economic growth that they are routinely portrayed to be. (See "What Do Small Businesses Do?" NBER working paper 17041, Oct. 2011.) Small businesses are mainly skilled craftspeople, lawyers, doctors, real estate agents, shopkeepers, and restaurateurs. These businesses do little innovation. They provide relatively standardized goods and services for existing customer bases. The researchers also found that once established, most small firms do not grow or are not expected to grow. Moreover, many of them do not want to grow. One reason for this is that many small business owners got into the business for themselves for non-pecuniary benefits such as wanting a flexible schedule or to be their own boss.

Hurst and Pugsley acknowledge that there can be good reasons for public policy to support small businesses, such as market failures that give those companies inadequate access to capital and low returns on their research and development. But the authors see subsidies for simply being small as "misguided." They conclude that those subsidies would be "less distortionary if they were targeted at growth and innovation as opposed to being mostly linked to firm size." It would be far better to direct subsidies to the subset of small businesses that aspire to grow and innovate.

Venture Capital

What types of small businesses are most likely to grow and innovate? Citing several studies, Hurst and Pugsley point out that firms that seek venture capital funding are much more likely to grow than other small firms. Therefore, we conclude here that it would be far more cost-effective for the federal government to promote small business job creation with incentives for venture capital than with across-the-board rate reductions for the wealthy.

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The idea of providing tax incentives for venture capital is hardly new. Jim Poterba of the Massachusetts Institute of Technology has argued that capital gains relief, if targeted to venture capitalists, can be an effective job creator (''Venture Capital and Capital Gains Taxation,'' NBER working paper 2832, July 1989). Several states — including Ohio, Kansas, Minnesota, Indiana, and Wisconsin — provide tax credits for venture capital. China, Germany, and the United Kingdom have special tax incentives for venture capital creation. At the federal level in the United States, there has been advantageous capital gains treatment for qualified small business stock since 1993 under section 1202 of the code. But venture capitalists complain that the benefits are too stingy and the rules for qualifying are too complex and restrictive. (See Lisa Sergi, Scott Jones, and Mary Kuusisto, ''Small Business Stock Incentives — Time for a Fresh Approach,'' Oct. 2008, available at http://www.nvca.org.)

President Obama and several members of Congress have proposed amending section 1202 to remove restrictions and expand benefits (*Doc 2011-2096*, *2011 TNT 21-38*). And there also have been proposals for federal tax credits for venture capital investment (*Doc 2007-4814*, *2007 TNT 38-130*). The research described in this article provides justification for these efforts. It also provides a good reason for exempting venture capitalists from proposals to end capital gains treatment of carried interest. ■

Cost-Sharing Regulations Reflect Adherence to Aggregate Approach

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Treasury signaled in final, temporary, and proposed regulations issued December 16 and 19 that the discussion about whether to adopt a fundamentally different approach to cost-sharing agreements (CSAs) is over.

The new rules regarding methods of determining taxable income under a CSA largely reflect the 2009 temporary and proposed regulations (T.D. 9441, REG-144615-02) and adopt the guidance included in the temporary regulations on the comparable uncontrolled transaction method. (For the final regulations (T.D. 9568), see *Doc 2011-26562* or *2011 TNT 243-16*. For T.D. 9441, see *Doc 2008-27341* or *2009 TNT 1-4*. For REG-144615-02, see *Doc 2008-27342* or *2009 TNT 1-5*.)

The regulations follow several significant court cases in which the IRS defended its position that an aggregate valuation of interrelated transactions is often the best method of reaching an arm's-length result. (For *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (Dec. 10, 2009), see *Doc 2009-27116* or *2009 TNT 236-17*. For *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (Aug. 29, 2005), see *Doc 2005-18073* or *2005 TNT 168-4*.)

Gregory J. Ossi, a principal at PricewaterhouseCoopers LLC, said, ''The preamble reconfirms the IRS's commitment, and the requirement under the regulations, to value items in the aggregate and to look at returns generated over the life of the activity that takes place.'' The preamble states that conventional notions of economic life may not be applicable under the new rules, which generally require taxpayers to value buy-in payments using aggregate, all-in approaches covering projected returns for as long as the cost-sharing activity continues, he said.

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The adoption of the economic framework is disappointing to many taxpayers and practitioners. Eric D. Ryan, a partner at DLA Piper, said commentators were hoping that Treasury might reduce some of the complexity in the cost-sharing framework. ''Treasury and the IRS are basically wedded to a number of these principles, including the income method, which is one of the methods for computing the buy-in payment, and the periodic