DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

MARCH 11, 2005

MEMORANDUM FOR	**JEFFREY KUPFER, EXECUTIVE DIRECTOR PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM**
FROM	**ROBERT CARROLL** RC **DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)**
SUBJECT	**BACKGROUND MATERIALS ON THE TAX BURDEN ON INVESTMENT AND ENTREPRENEURSHIP**

Attached is a fact sheet on "The Tax Burden on Investment and Entrepreneurship," prepared by the Treasury Department's Office of Tax Analysis. We submit the materials as additional background for the hearing the President's Advisory Panel on Federal Tax Reform held on March 8, 2005. These materials should be considered public submissions to the Panel.

Attachments

Fact Sheet: The Tax Burden on Investment and Entrepreneurship

Importance of Small Business and Entrepreneurs

Changes in the individual income tax affect most businesses in the United States. That is because business earnings are often paid through the individual income tax when "passed-through" to business owners. The business income from sole proprietorships, farm proprietorships, partnerships, S corporations, etc., is all taxed at the owners' individual income tax rates. As shown on the chart below, in 2004, 31 million business owners are expected to receive this type of income and pay tax on this income through the individual income tax.

Owners of Pass-though Businesses in 2004

Type of Business	Returns (millions)
Owners of pass-through businesses:	
S Corporations	3.6
Partnerships	4.2
Sole Proprietorships	18.8
Farm Proprietorships	2.1
Individuals with rental activities	9.4
Total pass-through entities 1/	30.9

Source: U.S.Treasury Department, Office of Tax Analysis.

1/ Total does not equal the sum of components because some taxpayers are owners of more than one type of business.

These types of businesses are often small and entrepreneurial in nature, a source of innovation and risk-taking in the economy, and important contributors to economic growth. They start new businesses or invent new products; try out new technologies, new internal forms of organization, and new locations. Others follow their successes, leading to general increases in productivity, or learn from their mistakes.

- Small businesses employ over half the labor force and, according to the Small Business Administration, create approximately 7 out of 10 new jobs.
- Over the past decade, between 60 percent and 75 percent of annual employment growth has come from small businesses.
- By some estimates, small businesses generate 52 percent of the Gross Domestic Product (GDP).
- By one count, patents by small firms were cited in subsequent patent applications 28 percent more often than patents by larger firms.

How do entrepreneurs respond to taxes?

Lower tax rates have been found to affect small business and entrepreneurs in important ways by encouraging entrepreneurs to hire more workers and pay them higher wages, encouraging entrepreneurs to invest more, and increasing the pace at which firms grow. Reducing marginal income tax rates on entrepreneurs has also been found to increase the likelihood of starting a business, decrease the likelihood of exiting from entrepreneurship, and lengthen the duration of entrepreneurial ventures.

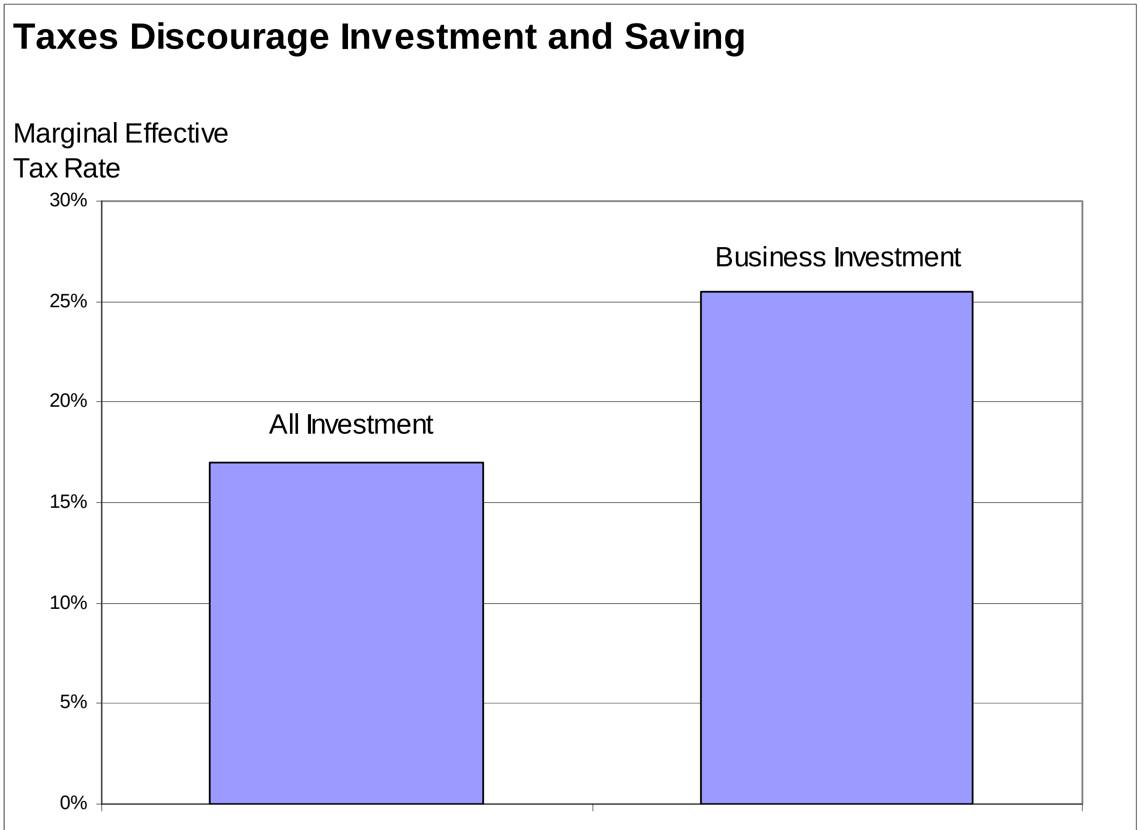
Importance of Saving and Investment to the Economy

Saving and investment are important for economic growth because they lead to greater capital formation, higher productivity, and, ultimately, higher living standards. Taxes on capital income drive a wedge between the return produced by an investment and the return received by the investor. Reducing this wedge would encourage economic growth through higher saving and investment, and, ultimately, lead to higher living standards.

- As shown in the chart below, the current tax system imposes an average marginal effective tax rate of about 17 percent on all investment. A lower level of tax on overall investment would generally encourage economic growth.
  - This estimate reflects the tax on business investment in the corporate and non-corporate sectors (e.g., sole proprietorships, partnerships and S corporations), as well as the tax treatment of investment in owner-occupied housing.

- Also, business capital is taxed at a much higher rate than other capital in the economy – at an effective marginal tax rate that exceeds 25 percent.

Both a lower overall level of tax on investment and more even tax treatment between different types of investment (e.g., business investment and other investment) would generally encourage economic growth.



Note: Marginal effective tax rate is the share of an investment's economic income needed to cover taxes over the investment's lifetime.

Tax Differences in Investment Across Sectors in the Economy

Investment in the corporate sector is generally taxed more heavily than investment in other sectors of the economy. Investment in higher taxed activities is discouraged in favor of investment in lower taxed activities and generally leads to a misallocation of capital in the economy, slower economic growth, and, ultimately, lower living standards.

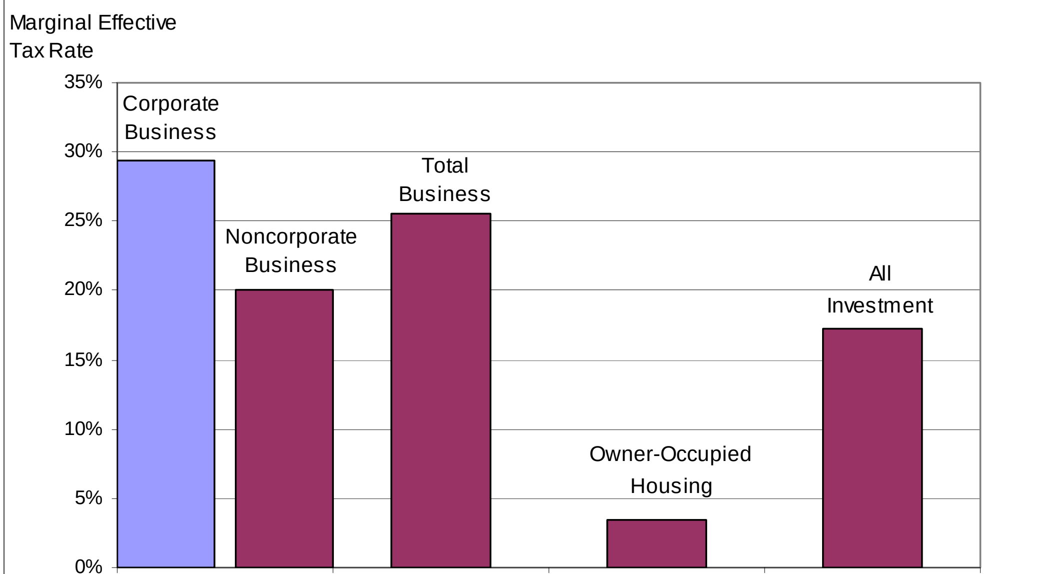
As shown in the chart below, the federal income tax imposes a very different tax burden on investment depending on the sector (e.g., corporate business, non-corporate business, etc.).

- Income from investment in the corporate sector is heavily taxed because of the double tax on profits. Corporate profits are taxed first under the corporation income tax and again under the individual income tax, when paid out as a dividend or received as a capital gain on the sale of shares.

- In contrast, income from investments in non-corporate businesses (e.g., sole proprietorships, partnerships) is taxed once.

- Income from business investment (corporate plus non-corporate) is generally taxed much more heavily than other investment.

Investment is Taxed Differently Across Sectors

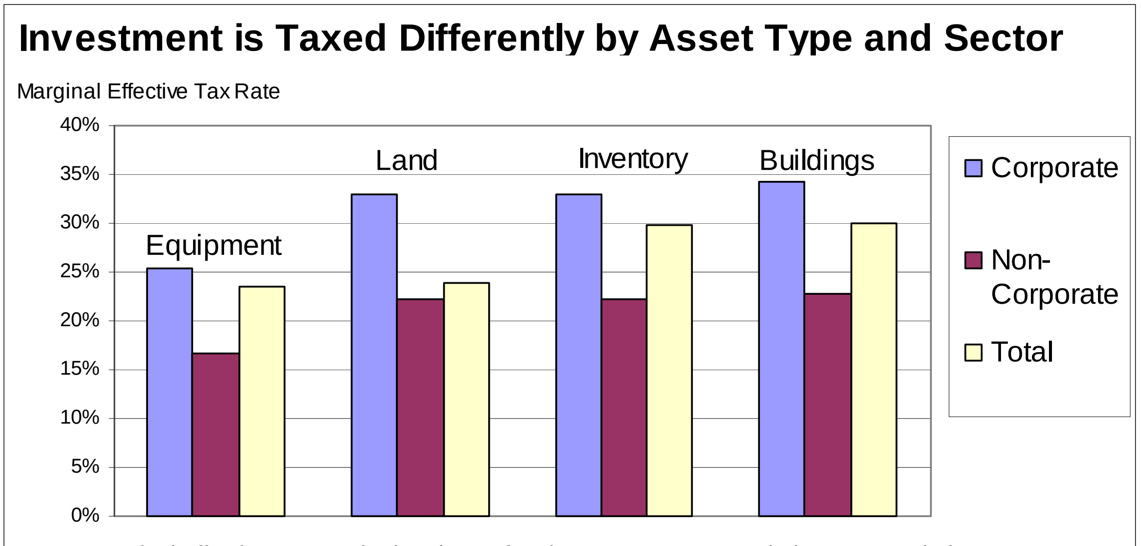


Note: Marginal effective tax rate is the share of an investment's economic income needed to cover taxes over the investment's lifetime.

Tax Differences Across Assets and Sectors

Under the current tax system, some investment is taxed more heavily than others depending on the type of asset purchased and business sector (i.e., corporate, non-corporate). This uneven treatment creates a tax bias that discourages investment in high taxed activities. This tax bias reduces our productivity because tax considerations compete with market fundamentals in guiding investment decisions.

As shown in the chart below, the tax system discourages investment in buildings, land and inventories relative to equipment. As noted above, business investment is generally taxed more heavily relative to other investment, particularly in the corporate sector.



Note: Marginal effective tax rate is the share of an investment's economic income needed to cover taxes over the investment lifetime.

Tax Differences in the Decision to Finance with Debt or With Equity

The federal income tax allows corporations to deduct interest from taxable income. Consequently, interest paid on a debt financed investment is not burdened by the corporate income tax imposed on the borrower, although the interest is taxed as income to the lender.

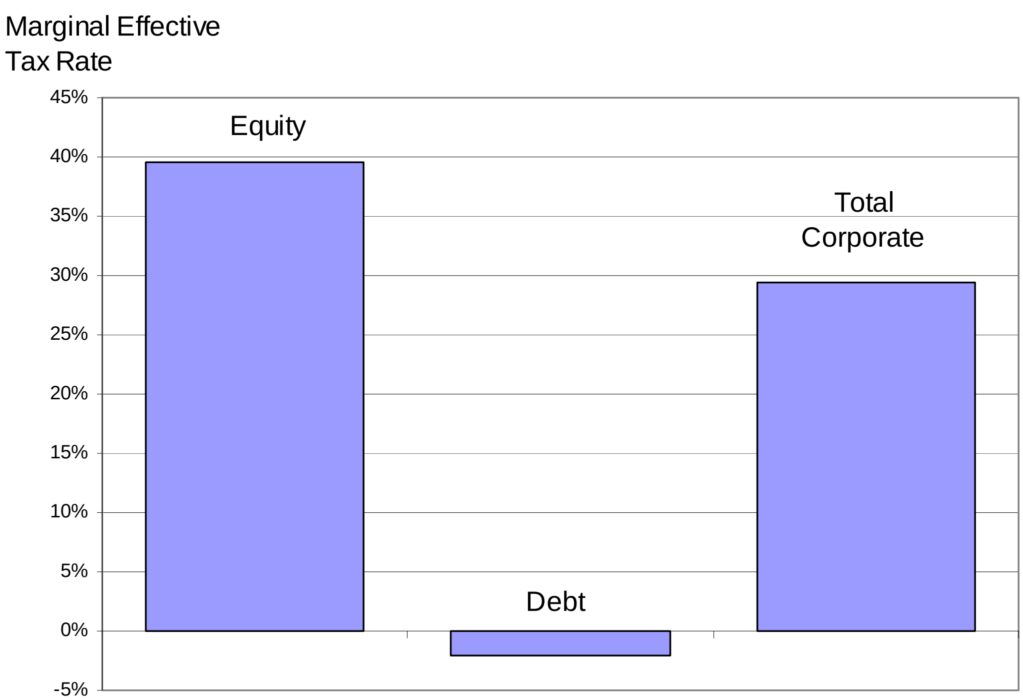
In contrast, as discussed above, the federal income tax imposes two layers of tax on corporate profits. Profits are taxed first under the corporate income tax and again under the individual income tax when received as dividends or realized as capital gains upon the sale stock.

As shown in the chart below, this differential tax treatment results in a large tax advantage for debt financed over equity financed investment.

- Debt financed investment is actually subsidized under the current tax system (i.e., debt faces a negative tax burden) due to accelerated depreciation and because the tax system does not adjust interest flows for inflation.

The tax differential in favor of debt finance creates an incentive for firms to borrow and a higher level of leverage in the economy.

Tax System Favors Debt Financed Investment



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