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Why Family Businesses Matter

What Do They Look Like, How Many Are There, and How Much Do They Contribute to Society?

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State and local politicians often argue that governments should use tax breaks and other incentives to attract large corporations to their jurisdictions because corporations employ many people. Family-owned businesses, each of which employs few people on average, are often regarded as occupying niche markets and ignored as being of little economic significance. A cursory look at the data appears to support this view. The average non-family business with paid employees employs more than three times the number of workers as does the average family business. This, however, ignores differences in the *numbers of firms*. Family firms outnumber non-family firms by almost four to one (Figure 1), meaning that state and local governments would likely see better job growth from adopting family business-friendly policies than from seeking to tilt the playing field in favor of large firms.

To make matters worse, it is not clear that the lucrative incentives that state and local governments offer to large corporations actually generate jobs. The Mackinac Center for Public Policy has studied the relationship between government subsidies and job creation over the period 1998 through 2002 in which several Michigan companies received a total of $120 million in government incentives in exchange for the promise that the companies would create 775 jobs. The Michigan auditor general's office subsequently found that the number of jobs at the companies had actually declined by 222.[1] Similarly, the Tax Foundation reports that every independent study of film tax credits have found that the credits are money-losers for the states with the average state recouping 30 cents for every dollar of incentives it provides to the film industry.[2] Despite this, many states actually compete with each by offering ever more lucrative film tax credits.

What Are Family Businesses? Every five years, the U.S. Census Bureau conducts the Survey of Business Owners (SBO) and the U.S. Department of Agriculture conducts the Census of Agriculture (COA). The SBO is a periodic survey of all nonfarm businesses that file IRS tax forms as either proprietorships, partnerships, or any type of corporation, and have annual receipts of $1,000 or more.[3] The SBO classifies a business as a "family" business if two or more members of the same family own the majority of it.[4] By this definition, almost 3.9 million family businesses responded to the 2007 SBO.[5] This definition is too stringent because it excludes both single-owner businesses and family-owned farms. Under the SBO's definition, a business that is run by a family but that is owned by a single

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member of that family would not be classified as a family business, even if the business employed other family members. In 2007, more than 1.8 million single-owner non-farm businesses responded to the SBO survey.[6]

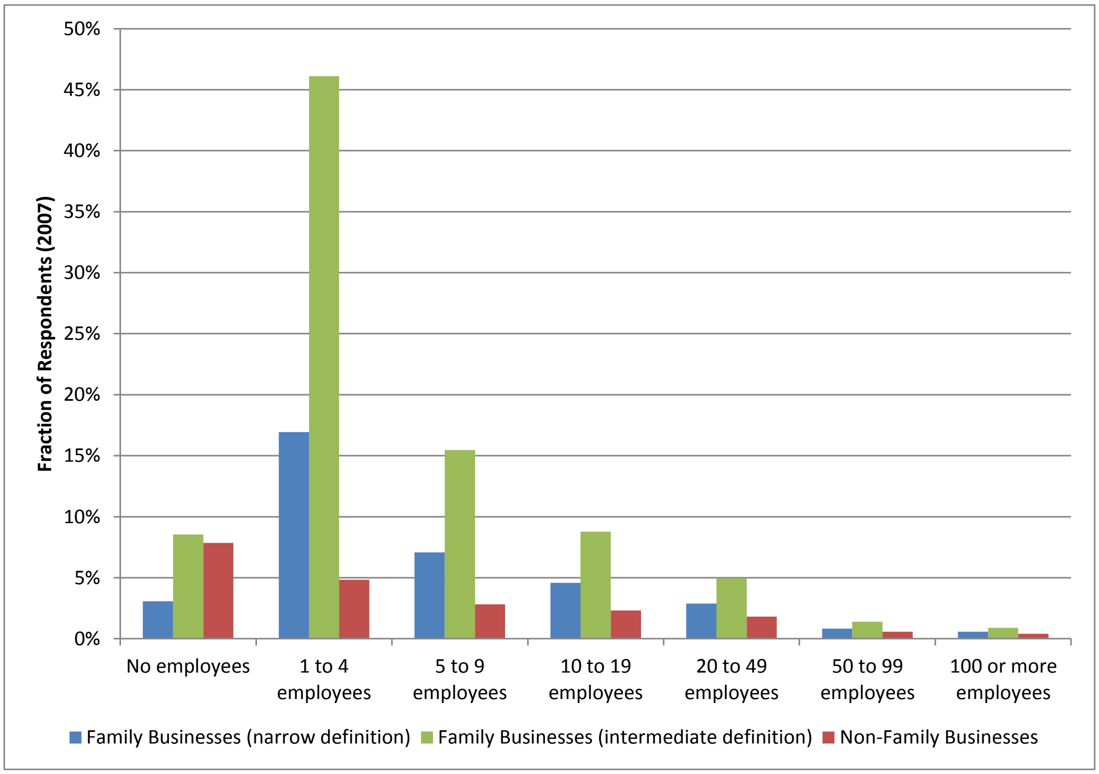

Figure 1. *The largest fractions of family and non-family businesses have between one and four employees. The fraction of family businesses that have larger numbers of employees drops more quickly for family businesses than for non-family businesses. Definitions of "family businesses" are provided later in the paper.*[7]

The COA is a periodic survey of farms that classifies farms as either family/single-owner, partnership, corporation, or "other." According to the COA, there were 2.2 million farms as of 2007.[8] Of these, 1.9 million were either single-owner or family-owned. In 2007, 1.2 million farms reported that the principal operator had a primary occupation other than farming. To be conservative, let us assume that all of these part-time farms were either single-owner or family-owned and exclude them from our definitions of family business. Subtracting the part-time farms, leaves almost 700,000 full-time, single-owner or family-owned farms

Figure 2 shows estimates from the 2007 SBO and COA surveys. The numbers do not represent a true census because they are not adjusted for non-respondents. As such, the true numbers of businesses are greater than the numbers shown here.

Consider three definitions of "family business". The narrow definition includes only non-farm, family-owned businesses (the blue in

Figure 2). By this definition, family businesses comprise about 3.9 million out of 15.9 million farms and businesses that responded to the surveys, or about 25 percent of businesses and farms in the survey. The intermediate definition adds to the narrow definition non-farm single-owner businesses (the green in Figure 2). The broad definition adds to the intermediate definition full-time family-owned and single-owner farms (the green and red in

Figure 2). By this definition, family businesses number over 6.4 million, or 40 percent of businesses and farms in the SBO survey.

Family Business Definitions

- Narrow definition: Non-farm family-owned businesses.
- Intermediate definition: Non-farm family-owned businesses and non-farm single-owner businesses.
- Broad definition: Non-farm family-owned businesses, non-farm single-owner businesses, and full-time family-owned and single-owner farms.

Figure 2 shows the breakdown of survey respondents according type (farm or non-farm) and ownership (family-owned, single-owner, and non-family owned).

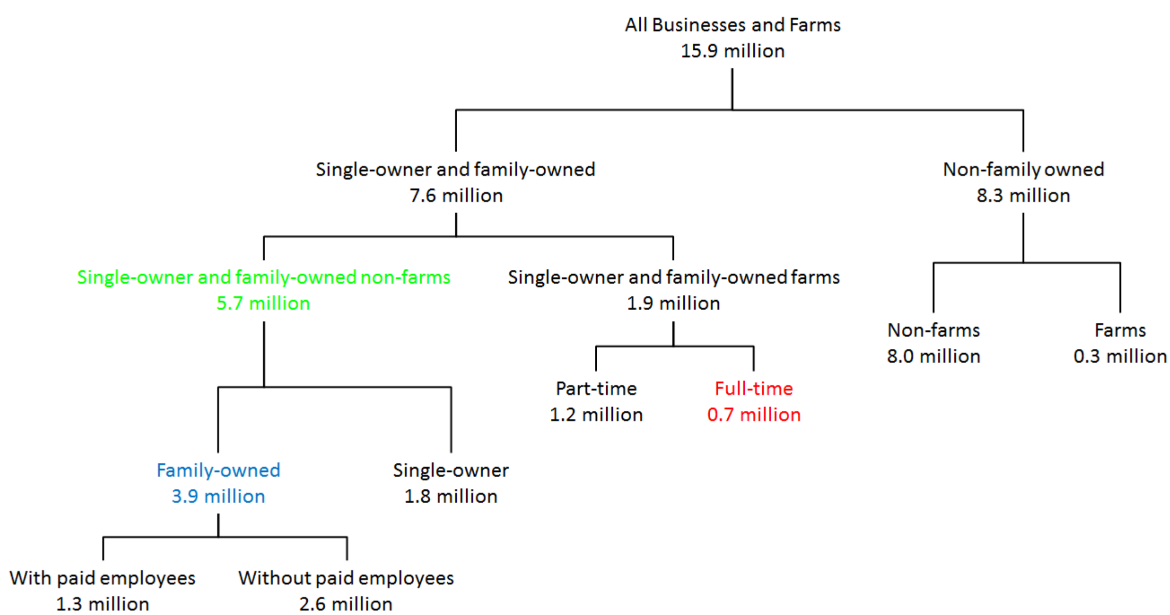

Figure 2. *Number of respondents to SBO and COA surveys, 2007.*[9]

The SBO only reports those businesses that respond to the survey. For the 2007, approximately 62 percent of businesses responded.[10] Consequently, the actual number of firms in the U.S., the number of workers they employ, and their total payrolls will vary from the numbers reported in this report. To the extent that firms of a particular type systematically are less likely to respond than are firms in general, the results reported here will be biased away from those particular firms.

Given that 62 percent of businesses responded to the SBO survey, if family firms were disproportionate non-responders, then the SBO data would underestimate the proportion of family businesses.[11] There are two obvious reasons a firm would not respond to the SBO: (1) the firm could be so small that its owner considers it merely a supplemental source of income rather than a "firm" in the traditional sense; (2) the firm could be so large that completing the SBO survey is a near-zero priority or it is unclear who within the firm should complete the survey. In the first case, the non-respondent would likely be a single-owner firm and would fall under the broad definition of family business. In the second case, the non-respondent would likely be a large company that falls under the SBO's definition of non-family business. The U.S. Census Bureau reports that many of the non-respondents were single-owner firms.[12] This points to a possible downward bias in the number of family businesses reported in

Figure 2.

Family Businesses and Employment. Family business jobs generate twice the total income of non-family business jobs. Although family businesses paid salaries that averaged 23 percent less than salaries paid by non-family businesses, family businesses employed 180 percent more workers.

In 2007, family businesses (according to the intermediate definition) accounted for approximately 70 percent of reporting respondents' annual non-farm payrolls and 75 percent of respondents' employees.[13] According to the narrow definition, family businesses accounted for approximately 38 percent of reporting respondents' payrolls and 42 percent of respondents' employees. In 2007, non-farm wage and salary disbursements were over $6.4 trillion and employment in non-farm industries was over 115 million.[14] If these estimates can be applied to the population of all businesses, then family businesses generated between $2.5 and $4.4 trillion in income in 2007 (Figure 3) while employing between 48 and 85 million workers, in addition to the owners (Figure 4). In 2007, family businesses paid their workers less than did non-family businesses. Family businesses' payrolls averaged about $32,700 per worker (both including and excluding single-owner businesses), while non-family businesses' payrolls averaged $42,500 per worker.

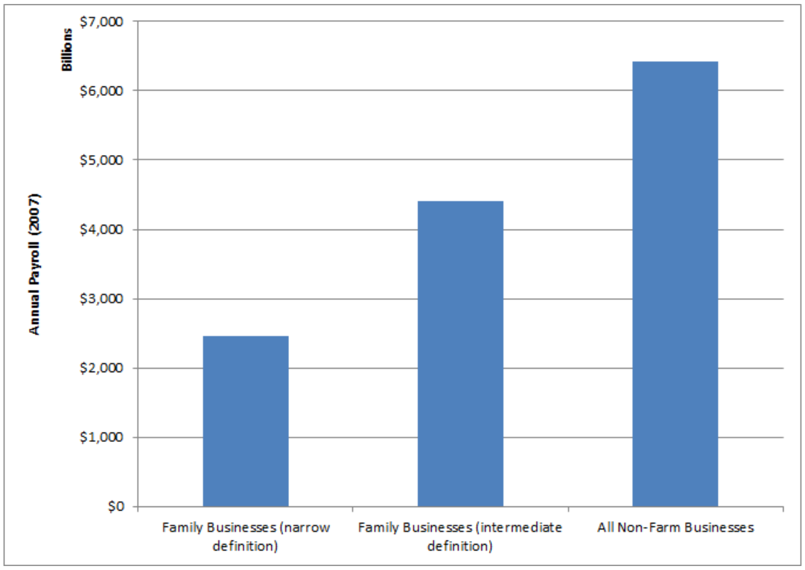

Figure 3. *In 2007, family businesses provided between $2.5 trillion and $4.4 trillion in workers' payrolls.*

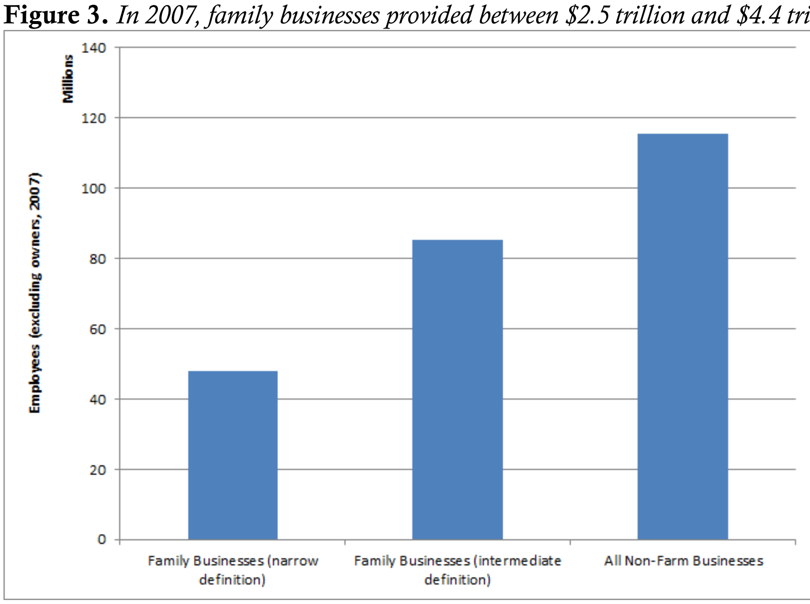

Figure 4. *In addition to their owners, family businesses employed between 48 million and 85 million workers in 2007.*

Family Businesses: Race, Gender, and Employment. The SBO survey asks respondents for the race and gender of the business owners and classifies the respondents' firms as "family-owned" versus "not family-owned." However, the SBO excludes single-owner firms from their definition of "family-owned," so its definition varies from the definitions of "family-owned" presented in this paper. Nonetheless, using SBO's definitions reveals some interesting results.

Minority ownership rates are the same among family and non-family businesses, at approximately 15 percent.[15] The rate of female ownership of firms with paid employees is more than two and a half times greater among family businesses than among non-family businesses. Among the respondents, almost 63 percent of family businesses are at least 50 percent female-owned, compared to less than 25 percent of non-family businesses (Figure

5). Average annual sales for female-owned family businesses with paid employees, at $1.27 million, are greater than sales for non-family businesses, at $831,000.

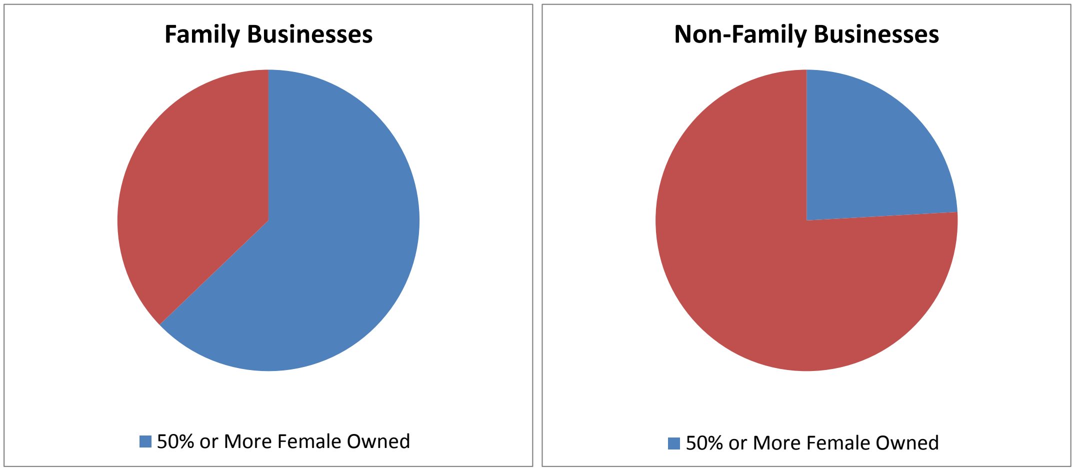

Figure 5. *Among respondent firms with paid employees, females have majority or equal ownership of 63 percent of family businesses versus only 24 percent of non-family businesses.*[16]

Distinguishing Family from Non-Family Businesses by Tax Return.
Constructing tax-related statistics requires examining IRS data, but the IRS does not classify businesses as "family" and "non-family." We can get a sense for how much family businesses earn and pay in taxes by looking at individuals who file business tax forms along with their personal income tax returns. We will examine personal returns that claim incomes or losses from sole proprietorships (Schedule C), rent or royalties (Schedule E), partnerships, and S-corporations. Sole proprietorships are family businesses according to the intermediate and broad definitions based on the SBO data. Rent and royalty income as claimed on Schedule E is earned by an individual, or a couple filing jointly, and so also falls under the intermediate and broad definitions of family business.[17] Partnerships and S-corporations may or may not be family businesses depending on the owners, according to our SBO definitions.

Tax Schedules Filed by Individual Business Owners

- Schedule C: Income from a single-owner business.
- Schedule E: Rent and royalty income earned by an individual or couple.
- Partnerships: Income from a multi-owner business.
- S-Corporations: Income from a small corporation.

IRS Tax Classification	Family Business Definition
Schedule C	Family business according to the intermediate and broad definitions
Schedule E	Family business according to the intermediate and broad definitions
Partnership	May or may not be a family business
S-Corporation	May or may not be a family business

Results in this section are based on analyses of 145,898 randomly selected individual tax returns filed for the 2006 tax year (the most recent year for which data are readily available). The returns are selected to represent the distribution of 138 million tax returns filed that year.[18] In 2006, almost 77 percent of individual tax returns indicated no business income. More than 23 percent indicated some form of business income, the majority of which indicated income from sole proprietorships (Figure 6). As there were 135.6 million tax returns filed in 2006, that means that more than 30 million households obtained some form of business income that year.

On average, business owners earn more income than non-business owners (Figure 7). In 2006, the average non-business owner had an adjusted gross income (AGI) of $43,600. The average business owner (including profits and losses from the business) had an AGI of between $71,000 (for sole proprietorships) and $331,000 (for partnerships).

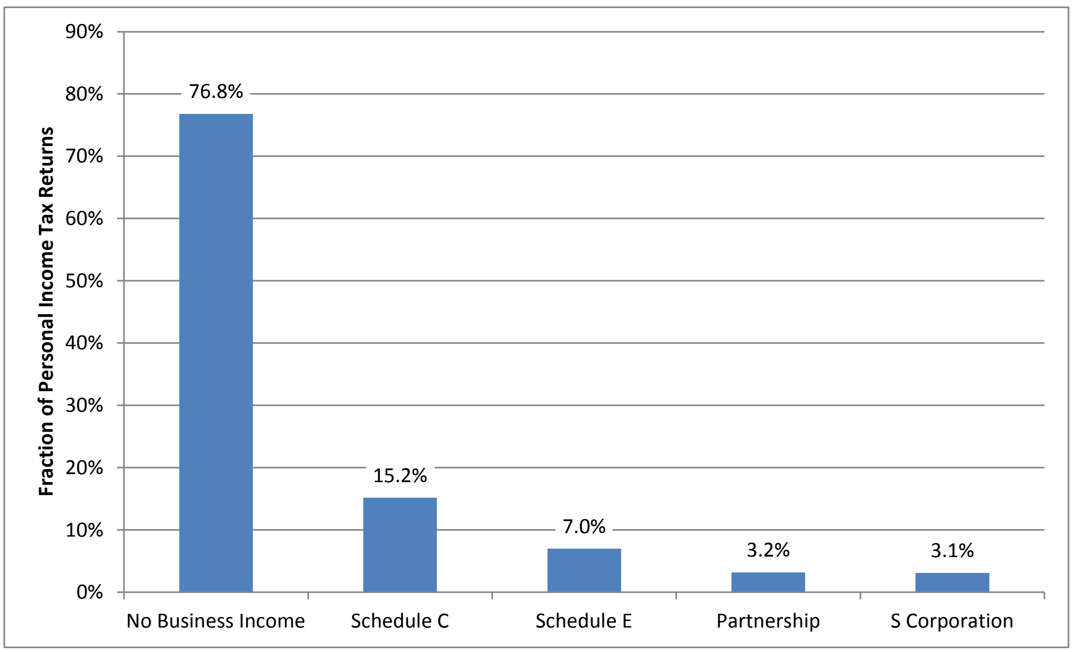

Figure 6. *In 2006, almost 77 percent of personal tax returns indicated no business income. More than 23 percent indicated some form of business income.*

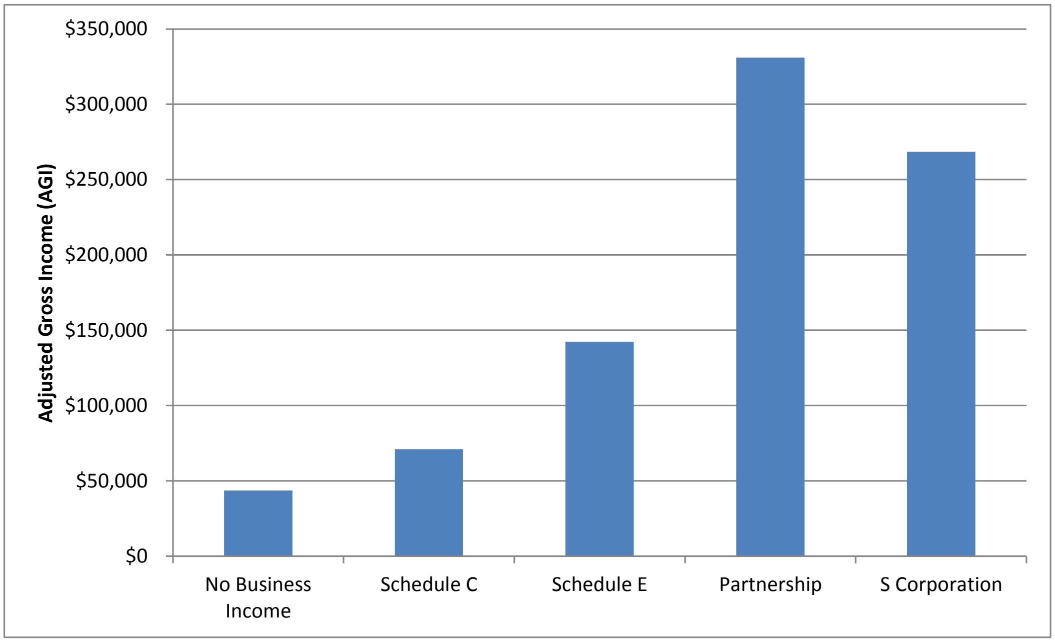

Figure 7. *Adjusted gross income for the average business owner was between 1.6 and 7.6 times that for the average non-business owner.*[19]

How Much Do Businesses Owners Pay in Taxes? It is widely believed that businesses owners make use of tax loopholes unavailable to the rest of us to shield their profits from taxation. We can test this by comparing taxpayers' adjusted gross incomes (AGI) to their taxable incomes. AGI is a person's actual income, and taxable income is the portion of the person's income that is actually taxed.[20] The larger is the difference between the two measures, the greater is the amount of taxes the taxpayer is avoiding. Figure 8 shows taxpayers' taxable incomes as a proportion of their adjusted gross incomes. If someone avoids all taxes, then his taxable income will be 0 percent of his AGI. If someone avoids no taxes, then his taxable income will be 100 percent of his AGI. If it is true that business owners make unfair use of tax loopholes, then their taxable incomes will account for a lesser share of their AGI while non-business owners' taxable incomes will be a greater share of their AGI. The evidence in Figure 8 actually shows the reverse. In 2006, people who did not own businesses paid tax on 64.1 percent of their incomes. People who owned businesses paid tax on between 69.9 percent of their incomes for sole proprietorships and 86.0 percent for partnerships. Rather than taking unfair advantage of tax loopholes to shield their incomes, the data indicate that business owners' incomes are more exposed to taxation than are the incomes of non-business owners.

Complaints that businesses are not paying their fair share of taxes focus on provisions in the tax code intended to help businesses. For example, the income tax rate for small corporations (those that earn less than $50,000) is only 15 percent versus 35 percent for large corporations. The tax rate gradually rises until it hits 35 percent when the company's income reaches $335,000. The intent of this provision is to give smaller companies the ability to retain and re-invest more of their profits. Businesses that manufacture goods in the U.S. are eligible for a tax deduction intended to reduce outsourcing. Firms that do business abroad can make use of provisions in the tax code that enable them to avoid taxes on profits so long as the money does not return to the United States. While individual tax loopholes make popular targets for the media and those who call on businesses and business owners to pay more taxes, and while there are certainly individual businesses and business owners who may use loopholes like these to avoid most of their tax liabilities, the fact is that business owners' incomes (on average) are exposed to higher average tax rates than are the incomes of non-business owners.

Not only are business owners' incomes more exposed to taxation, but business owners pay a greater proportion of their incomes in taxes. Figure 9 shows the average tax rates for business and non-business owners. The average non-business owner paid 10.2 percent of his income in federal taxes, while the average business owner paid between 13.2 percent and 20.8 percent of his income in federal taxes. In other words, the average business owner pays a tax rate that is between one-third more and twice as much as the rate paid by non-business owners. The same is true at the state and local levels. Non-business owners pay an average of 2.4 percent of their incomes in state and local taxes while business owners pay between 3.4 percent and 5.0 percent.[21]

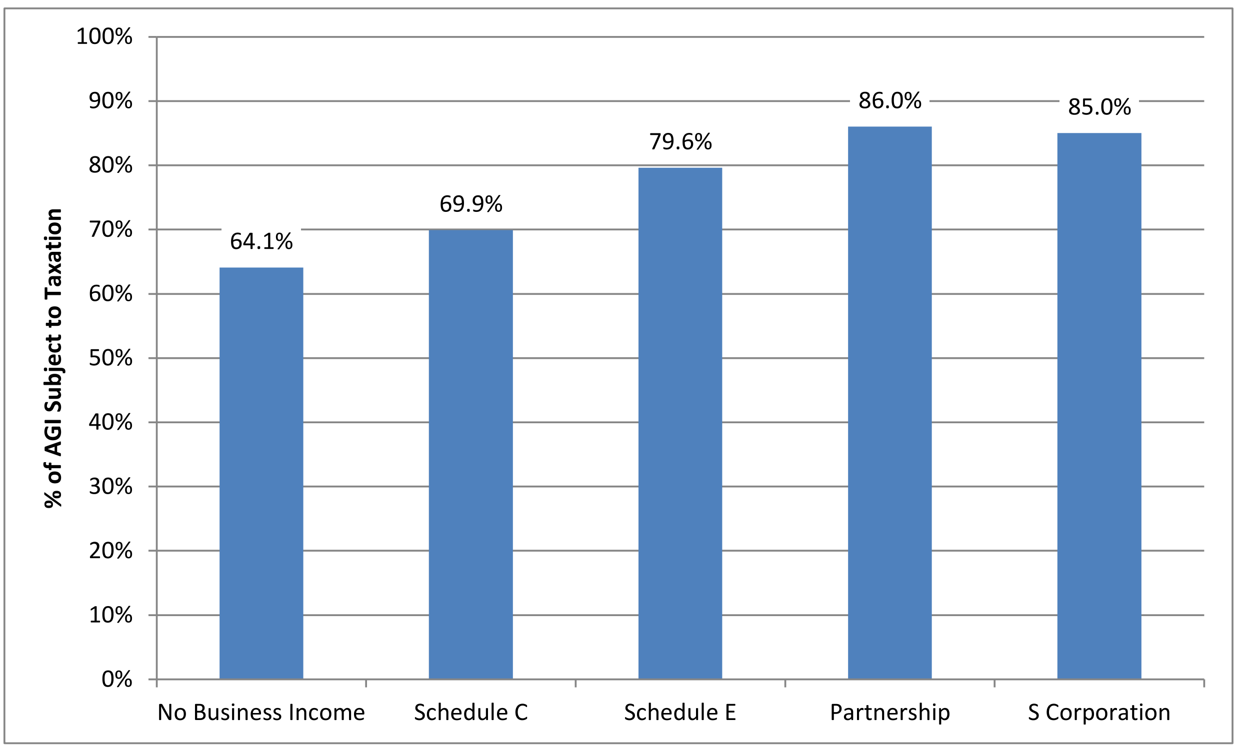

Figure 8. *Avoiding taxes reduces the percentage of AGI that is taxable. On average, non-business owners shield more of their incomes from taxes than do business owners.*[22]

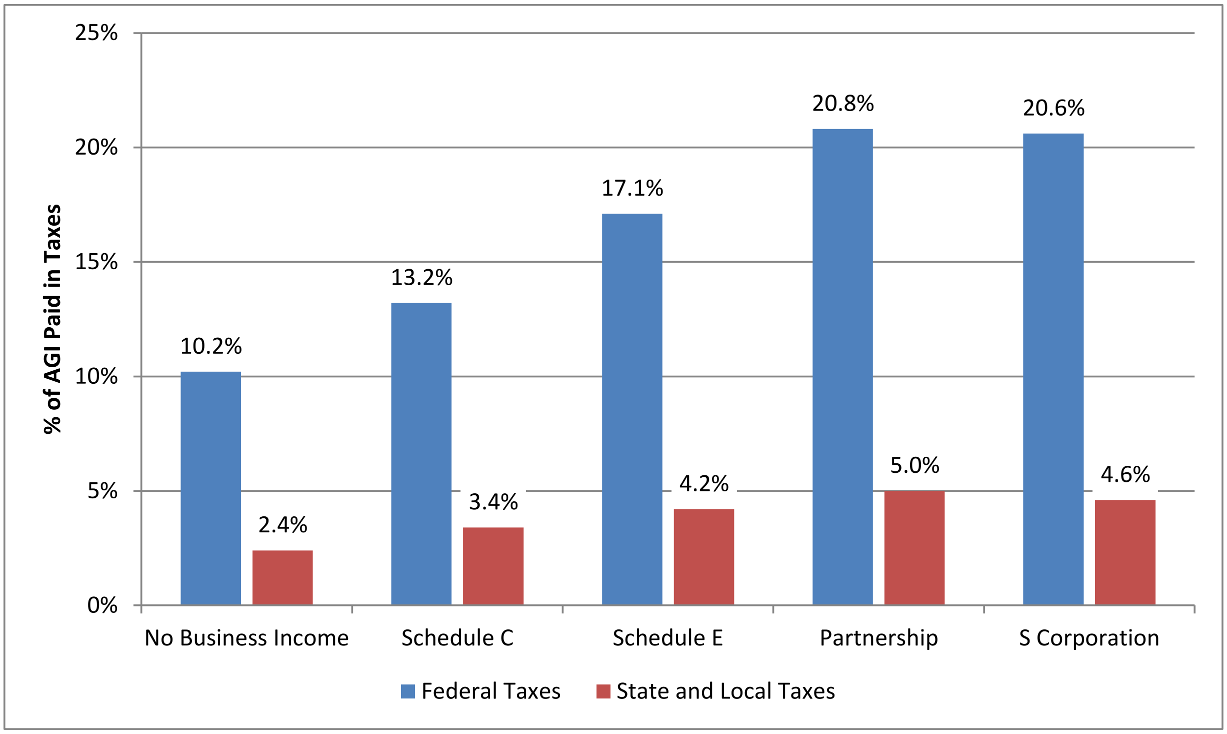

Figure 9. *Business owners pay a higher average tax rate (for both federal and state and local taxes) than do non-business owners.*[23]

How Much Do Businesses Owners Donate to Charity? Not only do business owners pay a higher tax rate than do non-business owners, but because they earn more income, the difference in the amount of taxes they pay is greater still. In 2006, the average non-business owner paid $5,500 in federal, state, and local taxes (Figure 10).[24] The average business owner paid between $11,800 (for Schedule C business owners) and $85,400 (for business partnerships owners). In 2006, the average business owner paid between two and 15 times the taxes paid by the average non-business owner. Comparing charitable donations, we see that this is not the case (Figure 11). Business owners voluntarily give at more than twice the rate of non-business owners.[25]

Business owners, on average, have higher incomes than non-business owners and so are natural targets in the call for higher income people to "pay their fair share". While "fair share" is never defined, it is illuminating to compare the total monetary contribution (via taxes and charitable giving) business owners make to society versus non-business owners. The average non-business owner contributed approximately $6,200 in federal, state, and local taxes, and in charitable contributions. The average proprietor contributed almost $14,000. The average partner contributed more than $98,000.

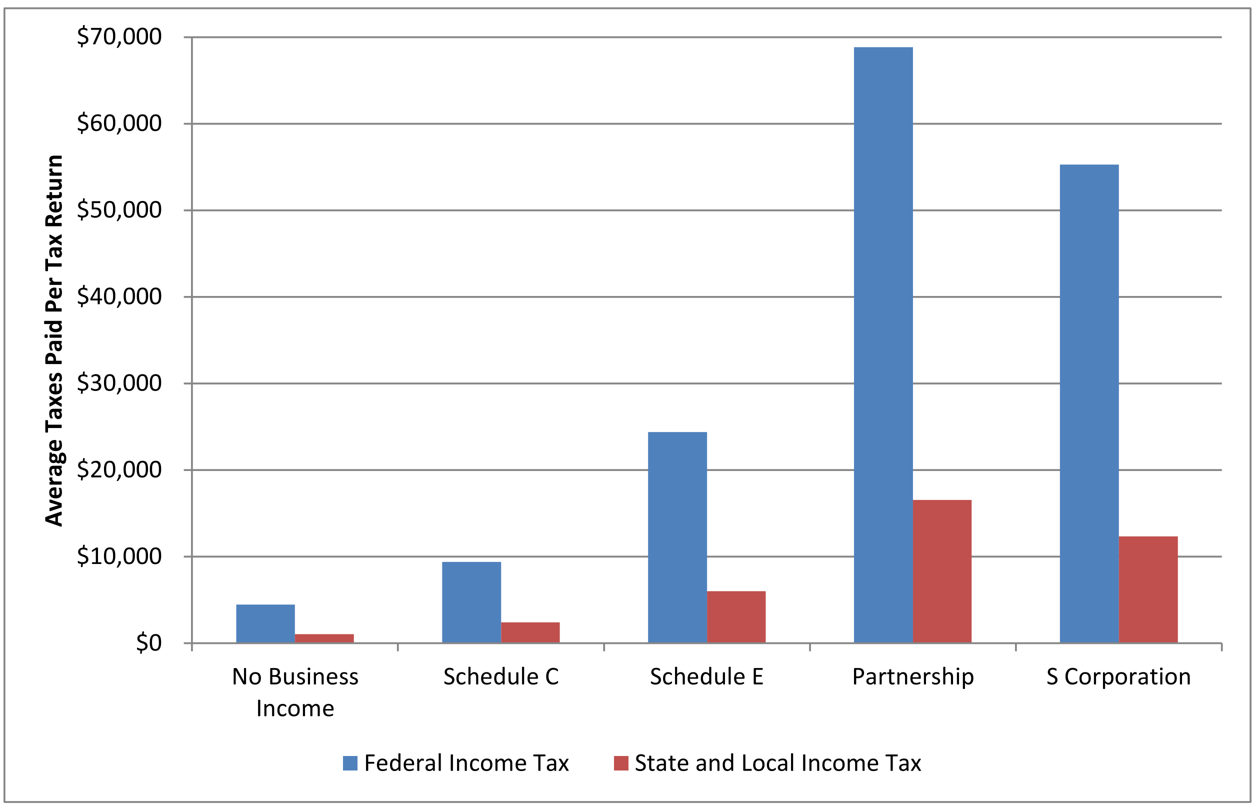

Figure 10. *The average business owner pays between 2 and 15 times the taxes paid by the average non-business owner.*

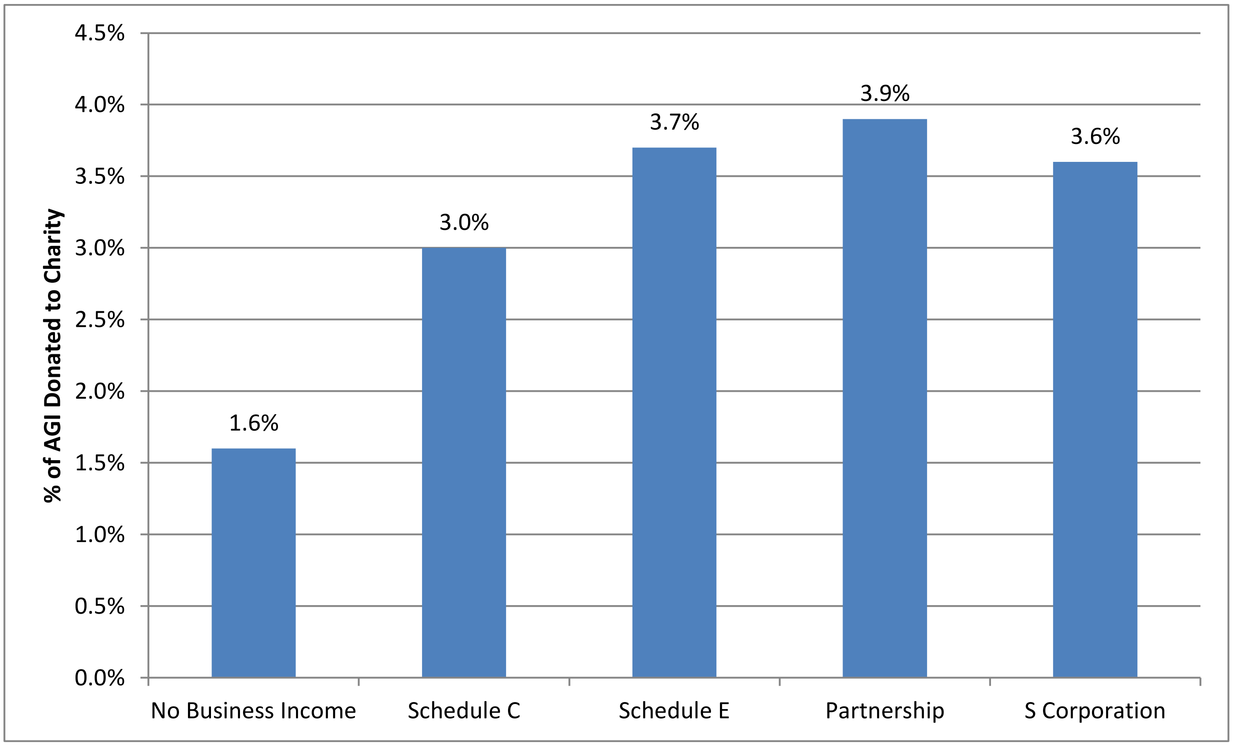

Figure 11. *Business owners contribute between 3 percent and 4 percent of their adjusted gross incomes to charity versus slightly more than 1.5 percent for non-business owners.*[26]

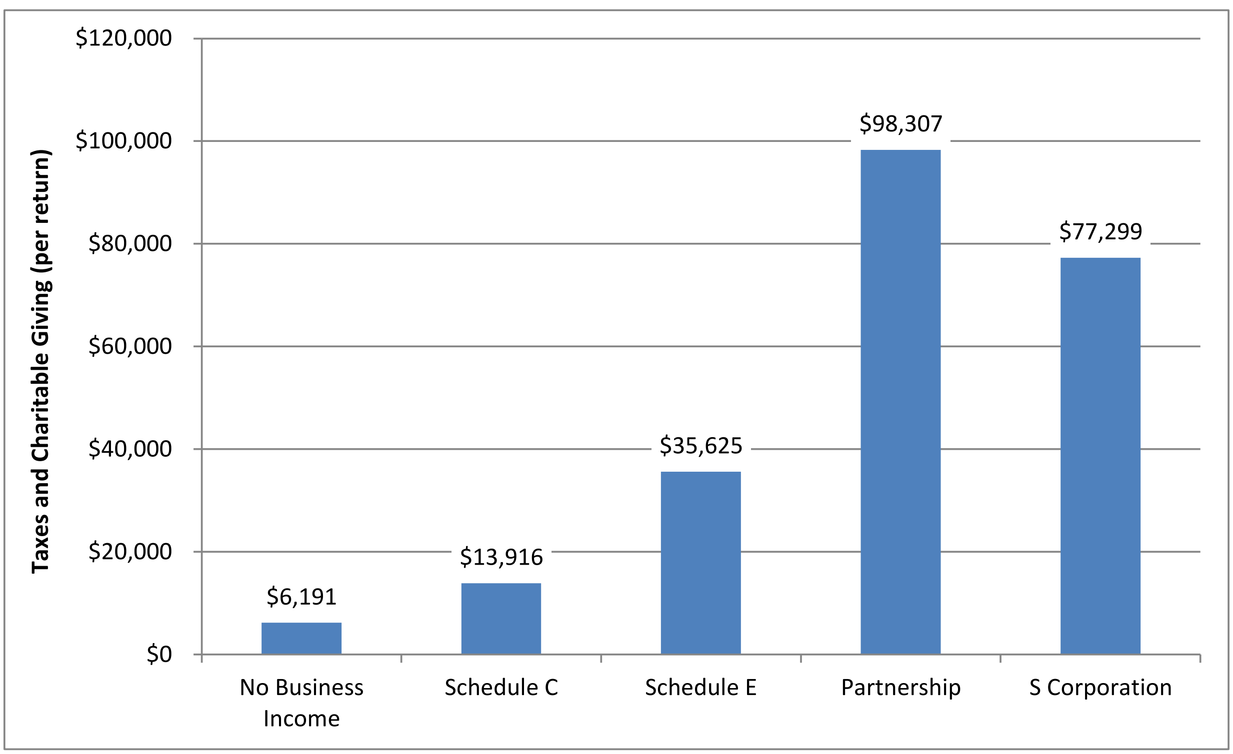

Figure 12. *In 2006, the average non-business owner contributed approximately $6,200 to society in the form of federal, state, and local taxes and charitable contributions. The average business owner contributed between $14,000 and $98,000.*[27]

Notes

[1] Sugg, J.F., 2007. The Folly of Southern Hospitality. Reason.com, April 19. (reason.com/archives/2007/04/19/the-folly-of-southern-hospital/print)
[2] Davies, A. and J. Harrigan, 2013. The Film Tax Credit Farce, Pittsburgh Tribune-Review, May 30. (triblive.com/opinion/featuredcommentary/4034056-74/tax-film-state)
[3] www.census.gov/econ/sbo/
[4] Question 9B asked, "In 2007, did two or more members of the same family own the majority of this business? *(Family refers to spouses, parents/guardians, children, siblings, or close relatives.)*"
[5] Table SB0700CSCB04 (factfinder2.census.gov). The Census Bureau has completed the 2012 Survey, but will not release its results until 2015 (www.census.gov/econ/sbo/releaseschedule12.html).
[6] Almost half of businesses the SBO surveyed did not complete the survey, did not complete all questions in the survey, or indicated that certain questions were "not applicable".
[7] Table SB0700CSCB06 (factfinder2.census.gov)
[8] Table SB0700CSCB09 (factfinder2.census.gov)
www.agcensus.usda.gov/Publications/2007/Full_Report/Volume_1,_Chapter_1_US/st99_1_001_001.pdf).
[9] Numbers represent the number of complete survey respondents, not the total number of firms. The total number of firms that responded to the 2007 CBO survey was 27,092,908. Adding the farms from the COA survey brings the total number of businesses in the two surveys to 29,297,700. The difference between this number and the total number of businesses shown in

Figure 2 is the number of non-respondents, partial respondents, and the number that marked relevant demographic questions as "not applicable".
[10] www.census.gov/econ/sbo/methodology.html
[11] www.census.gov/econ/sbo/methodology.html#2007treatment
[12] www.census.gov/econ/sbo/methodology.html
[13] See footnote 9.
[14] U.S. Bureau of Economic Analysis: Monthly Personal Income & Outlays.
[15] Table SB0700CSCB04 (factfinder2.census.gov)
[16] Table SB0700CSCB05 (factfinder2.census.gov)
[17] Rent and royalty income earned by a partnership is not claimed on Schedule E.
[18] We thank Bill Beach, Guinevere Nell, and Patrick Tyrrell of the Heritage Foundation for their help in providing and explaining the data.
[19] IRS individual tax return sampling, 2006.
[20] AGI includes all sources of income and subtracts only penalties for early retirement savings withdrawals, student loan interest, and jury pay.
[21] Because IRS filings include state and local tax information only for those who itemize deductions, the estimate of state and local tax rates applies only to non-business owners who itemize.
[22] IRS individual tax return sampling, 2006.
[23] These figures exclude self-employment taxes on the assumption that the portion of Social Security and Medicare taxes that are paid by employers on behalf of employees are, ultimately, paid by employees in the form of reduced wages. Since the employer's half of Social Security and Medicare taxes do not appear on non-business owners' tax returns, it is appropriate to exclude self-employment taxes from the calculations involving business owners' taxes. IRS individual tax return sampling, 2006.
[24] State and local taxes, which averaged $1,050 per tax return, are estimated based on non-business owners who itemized their deductions.
[25] A common misconception is that the rich give to charity only because doing so reduces their tax liability. It is true that donations are tax deductible, but one dollar in donations reduces the donor's tax liability by less than one dollar. Thus, if the person's goal were merely to end the day with more money in his pocket, he would donate zero even if the donation were tax deductible.
[26] Non-business owner estimates are based on non-business owners who itemize.
[27] This ignores self-employment taxes (for business owners) and the employer's half of Social Security and Medicare taxes (for non-business owners).