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Small Ball for Small Business:

Ending High-End Bush Tax Cuts Likely to Have Little Effect on Small Business Job Creators

BY ALLAN FREYER

KEY FINDINGS

- **Allowing the 2001 and 2003 tax cuts on incomes above $250,000 to expire in 2013—changing the top marginal tax rate from 36 percent to 39.6 percent—would affect only a small percentage of small businesses, and those that would be affected would face minimal barriers to capital reinvestment and jobs creation as a result.**
- **These tax changes only apply to small businesses that file through the personal income tax code and have no impact on those that pay corporate income tax, so many of North Carolina's largest businesses—and employers—would not be affected.**
- **According to the U.S. Department of Treasury, only 2.5 percent of the small-business owners that file through the federal personal income tax code have incomes—i.e., after making capital investments and meeting payroll—in excess of $250,000 per year and would be affected. These small business owners would still receive tax cuts on the portion of their incomes below that threshold.**
- **Only a quarter of total small-business income would be affected by this tax change, because 74 percent of the nation's small-business income is earned either by filers who bring home less than $250,000 in income or by entities that are not small businesses as traditionally understood (e.g., law firms, partnerships, and rental properties). Only 7.9 percent of filers with small-business income have any employees.**
- **Minimal changes in the top marginal rate will have limited effect on the investment decisions of these small businesses because their *effective* tax—the level of taxation after taking into account various deductions and credits—is already low, due to various existing small business write-offs related to equipment, capital loss, and perhaps most critically, payroll.**

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Introduction

As Congress returns for a lame-duck session, perhaps the most critical piece of unfinished business involves the “fiscal slope”—the looming expiration of $5 trillion in tax cuts signed under Presidents Obama and Bush, coupled with the phase-in of $1.2 trillion in automatic spending cuts to federal defense and non-defense programs, known as sequestration, that will take effect beginning in 2013. This debate has become intertwined with negotiations around a broader package aimed at reducing long-term federal budget deficits by $4 trillion over the next decade and stabilizing the growing federal debt.

The debate over the fiscal slope and long-term deficit reduction is occurring at a time when the official economic recovery remains sluggish. Therefore, any discussion of how to approach the expiration of tax cuts and the deficit must consider the macroeconomic impact as well as the impact on individuals and households of different incomes. At the heart of the discussion is what to do with the marginal rate reductions and special breaks on investment income originally passed in 2001 and 2003 (also known as the Bush tax cuts) and whether to allow the tax cuts to expire on incomes above $250,000.

Opponents of allowing the tax cuts to expire on income above $250,000 argue that the resulting tax increase would disproportionately affect small business owners and, in doing so, damage recovery in the overall economy. Specifically, they say the expiration of the tax cuts would affect a large number of small business owners by degrading their ability to promote capital investment, meet existing payroll, and ultimately increase job creation—and in the process, hold back macroeconomic growth.

To the contrary, recent research has demonstrated that allowing the upper income tax cuts to expire would affect a small *number* of small businesses, and that even those few would see no significant barrier to capital reinvestment and job creation as a result. Moreover, continuing tax cuts on income under $250,000 along with other tax policies that benefit middle-income families would provide significantly greater short- and long-term economic return on investment than extending the current lower marginal tax rates on high-income earners.

Small Businesses and the Personal Income Tax

It is critical to understand that the expiration of these high-end tax cuts would only apply to small businesses that both file through the personal income tax code and earn more than $250,000. As a result, these tax changes do not affect those small businesses that the are taxed under the corporate income tax, thus exempting most of North Carolina’s largest employers. Those small business owners that do file through the personal income tax would continue to receive tax cuts on their first $250,000 of income, assuming that the tax cuts on incomes below $250,000 per year are extended (as is commonly expected). As a result, they would only see an increase in the tax rate on the portion of their incomes above this threshold. Practically speaking, small business owners would see their tax rate on their income above $250,000 rise from 35 percent to 39.6 percent—the exact same rate in place during the boom years of the 1990s.[1] These small-business owners would only receive this tax increase on the *income* they realize *after* balancing out sales and costs, making capital investments, and meeting payroll. In effect, business owners would only see their taxes go up on *net* business income.[2]

Few Small Business “Job Creators” Affected

These realities dramatically narrow both the number of small business *owners* and the amount of small business *income* that would become subject to increasing the marginal rate on incomes over $250,000. Perhaps even more importantly, many of the

businesses that would be affected by this tax change are not small businesses that create jobs, thus reducing these policies' consequences for small business employment growth and the broader economy.

In terms of the specific *number* of small businesses affected, the U.S. Treasury estimates only 2.5 percent of small-business owners across the nation earn enough to be affected by the expiration of the tax cuts above $250,000[3] (the percentage would be similar in North Carolina[4]). This is because most of those filers claiming small business income on their personal income tax returns either take less than $250,000 home in income (and thus would not be subject to changes in the top marginal tax rate), or are not "small businesses" as traditionally understood because they either serve as vehicles for "pass-through income" from other business entities (see below) or have no employees (and thus cannot be classified as job creators). In fact, only 7.9 percent[5] of tax filers with any income from such businesses both earn more than $250,000 per year and have employees, suggesting that more than 90 percent of small business employers would be exempted from the tax increase. And of these small employers that would be affected, 68 percent should not be considered a "small business"—they are law firms, partnerships, and members of boards of directors, establishments that could not be reasonably considered a "small business." As a result, the impact of these tax changes on job creators is minimal.

This also calls into question another frequently voiced concern about the impact of expiring tax cuts on small businesses—the concern that even if just a small *number* of businesses would be affected, a majority of small business *income* would be taxed at a higher rate—with negative implication for job creation. This concern stems from the overly broad definition of small business described above.

Taking a more realistic approach, a U.S. Treasury report narrowed the definition of small-business owner to include only those with the following characteristics: (1) they have at least $5,000 in deductions related to business activities (a measure of genuine business-like behavior, in contrast to activities related to speaking fees or consulting income), (2) they have no more than $10 million in adjusted gross income (a measure of whether a business is "small" or not), and (3) they derive at least 25 percent of their incomes from business activities (another measure of business-like behavior). *Under this definition, the percentage of small-business income that would be subject to an increase in the top marginal tax rates would be 26 percent.*

As a result, 97 percent of small business owners and 74 percent of the income earned by actual small businesses income will see no tax increases if the tax cuts on income above $250,000 were allowed to expire. Yet recent research makes clear that even the remaining business owners and business income subject to the increased tax rates would see very few negative consequences for their hiring and investment. This is because the *effective* tax rate on small-business income—the level of taxation after taking into account various deductions and credits—is already close to zero for many small business filers,[6] regardless of the small changes in marginal rates,[7] due to various existing small business write-offs related to equipment, capital loss, and perhaps most critically, payroll.[8] This means that changes in the marginal rate would have little effect on a small business owner's taxable income, thus minimizing the disincentive to invest and generate new employment growth.

As a result, there appears to be little reason why these tax increases would hurt overall small business job creation and economic growth in the broader economy. This point is reinforced by recent research on the effect of taxes on economic growth, including a study by the Congressional Research Service that found that changes to marginal federal income tax rates has had minimal effect on employment and gross domestic product since the end of World War II.[9]

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Conclusion

As Congress pursues long-term deficit reduction and addresses the fiscal slope, evidence finds that allowing the tax cuts on incomes over $250,000 to expire will have little to no negative impact on small businesses. Few small businesses and only a small share of small business income would be affected. And while it is clear these tax changes will not *hurt* small business job creation, other policies may actually help promote employment growth.

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1 Huang, Chye-Ching and Marr, Chuck. (2012). Allowing High-Income Bush Tax Cuts to Expire Would Affect Few Small Businesses. Center on Budget & Policy Priorities. Washington, DC.

2 *Ibid*.

3 Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce, and Richard Prisinzano. (2012. Methodology to Identify Small Businesses and Their Owners. Office of Tax Analysis, U.S. Department of Treasury, Washington, DC.

4 According to the 2007 Economic Census, the percentage of total establishments with less than 500 employees (the definition of small business according to the Small Business Admimistration) in North Carolina very close to the same share at the national level.

5 Huang, Chye-Ching and Marr, Chuck. (2012). Allowing High-Income Bush Tax Cuts to Expire Would Affect Few Small Businesses. Center on Budget & Policy Priorities. Washington, DC.

6 Huang, Chye-Ching and Marr, Chuck. (2012). Allowing High-Income Bush Tax Cuts to Expire Would Affect Few Small Businesses. Center on Budget & Policy Priorities. Washington, DC.

7 Geunther, Gary. (2007). Small Business Tax Benefits: Overview and Economic Rationales. Congressional Research Service, Washington DC.

8 Huang, Chye-Ching and Marr, Chuck. (2012). Allowing High-Income Bush Tax Cuts to Expire Would Affect Few Small Businesses. Center on Budget & Policy Priorities. Washington, DC.

9 Thomas L. Hungerford. (2012). Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945. Congressional Research Service.

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