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Extending Bush Tax Cuts for High-Income "Small Business" Owners Would Further Enrich the Wealthiest Taxpayers While Doing Nothing to Create Jobs

As Congress prepares to take up legislation to boost small business job creation in the following weeks, some lawmakers argue that the legislation must extend parts of the Bush tax cuts that benefit the very rich.

Two ideas along these lines are being discussed. One is to extend income tax reductions for the very rich, at least for taxpayers who can be somehow classified as "small business" taxpayers. The second is to eliminate most of the federal tax on the estates of millionaires. Both of these proposals would allow the rich to continue to enjoy most of the tax cuts they received under President Bush while doing nothing to create or protect jobs.

Extending income tax cuts for small business owners is unlikely to boost job creation because:

- President Obama has already pledged to extend the Bush income tax cuts for 98 percent of taxpayers. Only 3 to 5 percent of small business owners are wealthy enough to lose some of their tax cuts under President Obama's proposal.
- Hiring decisions are generally not based on federal income taxes, but are based on whether or not there is demand for the goods or services that a business provides.
- Economists and analysts, including those at the non-partisan Congressional Budget Office, have concluded that extending income tax cuts would be the least effective of several policy options to create jobs.
- Enacting a "carve-out" or special break for "small businesses" would simply encourage all rich taxpayers to disguise their income as "small business" income.

Cutting the estate tax is also unlikely to boost job creation because:

- An even smaller percentage of small businesses would be affected by the federal estate tax under President Obama's proposal.
- Those few small businesses affected by the estate tax already enjoy special breaks that make it more manageable for closely held businesses and farms.
- It is very unlikely that the estate tax causes millionaires (the only people affected by it) to work less or invest less and therefore create fewer jobs. If anything, the estate tax could have the opposite effect.

President Obama's Approach to the Bush Tax Cuts

The tax cuts enacted under President George W. Bush expire at the end of this year. The debate in Congress over which of these expiring tax cuts should be extended has two parts.

First, Congress must decide what to do about the reductions in the personal income tax enacted under President Bush. For better or worse, Democrats and Republicans in Congress all agree with President Obama that the income tax cuts should be extended for 98 percent of taxpayers. All that is in dispute is whether or not the income tax cuts for the richest two percent should expire as scheduled (as President Obama proposes) or should be extended or made permanent (as Congressional Republicans propose).

Second, Congress must decide what to do about the reductions, enacted under President Bush, in the federal tax on the estates of millionaires. The Bush tax cuts included a gradual repeal of the estate tax which culminated in the complete disappearance of the tax in 2010. Congressional Republicans would like to make this repeal permanent. President Obama proposes not to permanently repeal the estate tax but to cut it in half. Only a fraction of one percent of deaths would result in estate tax liability under President Obama's proposal.

In other words, President Obama has agreed (for better or worse) to give supporters of the Bush tax cuts most of what they want.[1]

And remember that when we say the very richest taxpayers would lose part of their Bush tax cuts, that merely means that they would be paying taxes closer to what they paid at the end of the Clinton years.[2] It goes without saying that the economy was functioning better at the end of the Clinton years (when taxes were higher) than at the end of the Bush years (when taxes were lower).

Recent Proposals to Extend the Bush Tax Cuts for the Rich

For the last couple of years, Congressional Republicans have focused on making permanent the Bush income tax cuts for the richest two percent of taxpayers (since President Obama has already agreed to make them permanent for the other 98 percent) and permanently repealing the estate tax (which Obama would "only" cut in half).

Congressional Republicans and some Congressional Democrats have more recently taken a new tactic of presenting "compromise" proposals in the name of boosting job creation by "small businesses."

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[1]President Obama also signed into law some modifications to certain parts of the Bush tax cuts (related to the Earned Income Tax Credit and the Child Tax Credit) as part of the economic recovery act. A previous report from CTJ calculates how much low- and middle-income taxpayers would lose under the Republican approach, since the Republicans oppose making these changes permanent. Citizens for Tax Justice, "Republican Approach to Extending the Bush Tax Cuts Would Result in $56,400 Break for Richest 1% and *Higher* Taxes for Middle-Class, Compared to Obama's Approach," April 22, 2010. http://www.ctj.org/pdf/bushtaxcuts2010.pdf

[2]President Obama would partially extend one of the Bush tax cuts for the rich by taxing corporate stock dividends at a top rate of 20 percent. This is higher than the 15 percent rate that Bush enacted, but if Congress does nothing stock dividends would be taxed as ordinary income (at a top rate of 39.6 for the very rich) after the Bush tax cuts expire. The rich would also benefit from the reductions in rates in the lower income tax brackets.

First, some lawmakers argue that the Bush income tax cuts should be extended for taxpayers who are among the richest two percent in the case of "small business" owners. Second, they propose to cut the estate tax by two thirds (in terms of the revenue it collects) whereas President Obama proposes to cut it in half.

Neither of these ideas would do anything to create or sustain jobs. Instead, they would help the very richest Americans continue to enjoy the tax cuts they received under President Bush while draining revenue that could be used for more effective job creation measures.

A "Carve-Out" to Preserve the Bush Income Tax Cuts for Rich "Small Business" Owners

President Obama has proposed to allow the top two income tax rates to revert to their pre-Bush levels (meaning they would revert from 33 and 35 percent to 36 and 39.6 percent). He would adjust the brackets so that no married couple with adjusted gross income (AGI) less than $250,000, and no unmarried taxpayer with AGI less than $200,000, would be affected by the top two tax rates. He would also allow limitations on personal exemptions and itemized deductions to come back into effect for married taxpayers with AGI in excess of $250,000 and unmarred taxpayers with AGI in excess of $200,000.

Only about two percent of taxpayers in 2011 will have AGI in excess of this $250,000/$200,000 threshold. Since these amounts would be indexed for inflation, this percentage would not change much over time.

In other words, only two percent of taxpayers would no longer enjoy all of their Bush tax cuts under President Obama's proposal.

Republican (and some Democratic) lawmakers may offer amendments to the upcoming small business jobs legislation that would extend the top two income tax rates (the rates affecting those above the $250,000/$200,000 threshold) for "small business" owners. Or they may offer a separate bill to achieve the same thing. Such a proposal would do nothing to create or sustain jobs, for several reasons.

1. Only 3 to 5 Percent of Small Businesses Owners Are Among the Richest Two Percent

It's not yet clear how any such proposal would define "small business." It's generally agreed that the term "small business" usually refers not to taxable corporations (which pay the corporate income tax) but rather to businesses whose owners receive profits as personal income and pay personal income taxes on them. These businesses can take the form of partnerships, sole proprietorships, or "S corporations" (which are corporations whose profits are not subject to the corporate income tax, but are instead included in the income of their owners).

We define "small business income" to include income received by individuals from businesses of these types that they own and are actively involved in operating. This kind of income is called often called "active" business income, meaning that the person who receives it is actively involved in running the business. This distinguishes it from "passive" business income, which includes royalties, rents, capital gains, corporate stock dividends, interest, and income from partnerships or S corporations that the recipient is not involved in.

Passive income is excluded from our definition of small business income. Passive income is received by investors who are not actually participating in the business generating this income. Most people wouldn't think of someone living off of stock dividends, interest payments or other income from businesses that they are not involved in as a "small business" person.

We define small business owners as those taxpayers who report to the IRS that over half of their adjusted gross income (AGI) is active business income.[3]

We estimate that only 5 percent of small business taxpayers (as we define them) would lose any of their Bush income tax cuts under President Obama's proposal.

Other estimates using a different definition of "small business owner" can come to a slightly different result. For example, the Center on Budget and Policy Priorities cites a letter from the Congressional Joint Committee on Taxation (JCT) estimating that 3 percent of taxpayers with *any* business income would benefit from an extension of the reductions in the top two income tax rates. The definition of "business income" used includes active business income and some passive business income.[4]

Another possibility is that lawmakers will focus extension of the high-income Bush tax cuts on an even narrower group of taxpayers. For example, there has been some talk of allowing taxpayers with income from an S corporation to continue to enjoy the Bush income tax cuts, even if their AGI exceeds $250,000/$200,000. In a previous analysis we concluded that only 2.1 percent of small business taxpayers receive more than half their AGI from an S corporation and are rich enough to lose some of their Bush income tax cuts under President Obama's proposal.[5] We also noted that many S corporations are not "small" at all.

2. Hiring decisions are generally not based on federal income taxes, but are based on whether or not there is demand for the goods or services that a business provides.

Even for those few small business taxpayers rich enough to lose some of the tax cuts under President Obama's proposals, there are several reasons to believe this will have little or no impact on their hiring decisions.

First, money that a small business owner pays to an employee as wages or salary is not even included in the business owner's AGI or taxable income. A small business owner only pays taxes on business profits — what is left after wages and salaries and other operating expenses have been paid. Even if a small business owner wants to expand operations by purchasing new

[3]Specifically, we define small business income to include the sum of non-passive partnership income, non-passive Subchapter S corporation income, sole-proprietorship income (schedule C) and farm income (schedule F). Losses are not counted.

[4]Chuck Marr and Gillian Brunet, "High-Income Tax Cuts Should Expire on Schedule," April 1, 2010, Center on Budget and Policy Priorities. http://www.cbpp.org/cms/index.cfm?fa=view&id=3140#_ftn1

[5]Citizens for Tax Justice, "Loopholes for Wealthy Owners of "Subchapter S Corporations" Will Not Help "Small Business," April 22, 2010, http://ctj.org/pdf/scorps.pdf.

equipment, they typically benefit from small business "expensing." This means they pay no taxes on money used to purchase equipment.[6]

Second, the main calculus driving hiring decisions is not how much of one's profits a business owner can keep after paying taxes, but whether a new hire will increase profits at all. This depends on whether or not there is any demand for the good or services the business provides. No matter how low taxes are, no one is going to hire a person to produce something that no one wants to buy.[7]

3. Economists and analysts have concluded that extending income tax cuts would be the least effective of several policy options to create jobs.

The previous point explains why analysts believe that there are much better ways to create jobs than cutting income taxes for the rich.

The Congressional Budget Office (CBO) recently concluded that making permanent all the income tax cuts (including those for the richest taxpayers) was the least effective policy option for creating jobs.[8] The CBO found that for each dollar spent, infrastructure spending, aid to states and refundable credits for low- and middle-income families all would add far more to the gross national product (GDP) than extending income tax cuts.

Unlike extending the Bush income tax cuts, these other policies would result in consumption immediately or soon after being enacted. Infrastructure projects that are ready to begin, aid to states that can immediately be used to avoid layoffs that would otherwise be unavoidable, and refundable credits for families who will immediately spend any new money on necessities — all of these mean that money is immediately pumped back into the economy. On the other hand, income tax cuts that go disproportionately to the wealthy would largely be saved, meaning there is no immediate boost to the economy.

4. Enacting a "carve-out" or special break for "small businesses" would simply encourage all rich taxpayers to disguise their income as "small business" income.

It's extremely difficult to imagine how any "carve-out" meant to extend reductions in the top rates can be limited to small businesses. The likely result would be massive tax avoidance, since rich taxpayers would have an incentive to disguise their income as "small business" income.

For example, if a valued employee of a corporation is earning $500,000 in wages, what exactly

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[6]Small business owners can immediately deduct ("expense") up to $125,000 for the cost of equipment under section 179 of the tax code. This limit was temporarily doubled to $250,000 for equipment placed into service in 2009 and (through recent legislation) 2010.

[7]"For businesses to add to the payrolls they must first be confident that there is sufficient demand for whatever their new employees will produce," Mark Zandi, Moody's Economy.com, "Jump-Starting the Job Market: How Well Will a Job Tax Credit Work," February 8, 2010, http://www.economy.com/mark-zandi/documents/Job-Tax-Credit-020810.pdf

[8]Congressional Budget Office, "Policies for Increasing Economic Growth and Employment in 2010 and 2011," January 2010, http://www.cbo.gov/ftpdocs/108xx/doc10803/01-14-Employment.pdf.

would prevent that employee from forming his or her own “small business” and “selling” services to the corporation? It’s unclear how well rules could be written to avoid this result.

A Reduction in the Federal Tax on the Estates of Millionaires

The tax cuts enacted under President George W. Bush include a gradual repeal of the federal estate tax. Over a period of years, the amount of assets exempt from the tax increased gradually, and the estate tax rate decreased gradually, until the estate tax disappeared completely in 2010. But, like all the Bush tax cuts, this repeal of the estate tax expires at the end of 2010, meaning the estate tax will return at pre-Bush levels in 2011 if Congress does nothing.

But Congress is unlikely to do nothing because lawmakers have been subjected to an organized campaign to characterize the estate tax as unfair and economically unsound. In 2006, a report from Public Citizen and United for a Fair Economy documented how 18 extremely wealthy families coordinated to spend hundreds of millions of dollars to promote repeal of the federal estate tax, which would save them, collectively, over $70 billion.[9]

If the estate tax were to revert to the pre-Bush rules, it would exempt the first $1 million of assets per spouse, and would have a top rate of 55 percent. President Obama proposes to make permanent the federal estate tax rules that were in effect in 2009, including an exemption of $3.5 million per spouse and a top estate tax rate of 45 percent. This is estimated to cost $391 billion (including the additional interest on the national debt that will result) over the first ten years in which the impact will be fully felt. This amount is a little less than half the cost of full repeal of the estate tax.[10]

CTJ and other organizations have called for an estate tax compromise that would retain more estate tax revenue than the proposal President Obama has put forward. This more robust estate tax would exempt $2 million per spouse and would have a top rate of 45 percent for all but the very largest estates (a top rate of 55 percent would apply to the taxable portion of an estate in excess of $10 million).[11]

Since the per-spouse exemption was set at $2 million for several years while the repeal was being phased in, we know, roughly, how few estates would be taxed if the exemption was set at this level again. The most recent data from the IRS shows that only 0.7 percent of deaths resulted in estate tax liability during the years when the per-spouse exemption was set at $2 million.[12] If the exemption is set at $3.5 million, as President Obama proposes, even fewer

[9]Public Citizen and United for a Fair Economy, “Spending Millions to Save Billions: The Campaign of the Super Wealthy to Kill the Estate Tax,” April 2006. http://www.faireconomy.org/files/pdf/millions_billions.pdf

[10]Chuck Marr and Gillian Brunet, “Congress Should Not Weaken the Estate Tax Beyond 2009 Parameters,” December 2, 2009. http://www.cbpp.org/cms/index.cfm?fa=view&id=3017

[11]Americans for a Fair Estate Tax, “Statement of Principles on Estate Tax Legislation.” http://ombwatch.org/files/budget/AFETPrinciples.pdf

[12]Citizens for Tax Justice, “Latest State-by-State Estate Tax Data Show Why We Need a Strong Estate Tax,” December 2, 2009, http://www.ctj.org/pdf/estatetax2009.pdf; Center on Budget and Policy Priorities, “Congress Should Not Weaken the Estate Tax Beyond 2009 Parameters,” December 2, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=3017#_ftn7.

deaths will result in estate tax liability.

Late in 2009, the House of Representatives approved a bill that would make permanent the estate tax rules that were in effect in 2009. The Senate failed to act, and as a result, the estate tax has disappeared for 2010.

Opponents of the estate tax have realized that they do not have the votes to make estate tax repeal permanent, so they have lately turned to proposals that would eliminate most, if not all, of the tax. A proposal offered last year by Senators Blanche Lincoln (D-AR) and Jon Kyl (R-AZ) would set the per-spouse exemption at $5 million and the top rate at 35 percent. This would cost about two thirds as much as full repeal, whereas President Obama's proposal (which would make permanent the 2009 estate tax rules) would cost a little less than half as much as full repeal.

Proposals to Cut the Estate Tax Are Not Likely to Be Truly Revenue-Neutral

Various news outlets are reporting that Senators Lincoln, Kyl and others are exploring various ways of "offsetting" the costs of their proposed cut in the estate tax, but all of the ideas discussed so far involve budget gimmicks that would mask the true costs.

For example, a cut in the estate tax can be phased in over the period of years that lawmakers pay attention to for budget purposes, with the assumption that the rules in place in the final year (which implement the deepest cut) will be made permanent. In fact, this was the strategy implemented by President Bush and his supporters in Congress when they decided to phase in their estate tax repeal over several years. This approach has been adopted by Rep. Shelley Berkley (D-NV), who offered a proposal last year that was similar to the Lincoln-Kyl proposal but would phase the change in over a number of years.

Another potential budget gimmick might involve some proposal to "prepay" part of the estate tax before death, which would benefit those with assets that are likely to appreciate. Senator Maria Cantwell (D-WA) is said to be exploring this option, but it's unclear how exactly it would work. Such a provision might allow a temporary revenue gain (caused by people prepaying estate taxes before death) to mask the long-term costs of reducing the tax. Obviously opponents of the estate tax would not even be discussing such an option unless it ultimately reduced the tax — and the revenue it collects.

Senators have discussed closing loopholes within the estate tax to offset the cost of lowering rates and increasing exemptions, but it's unlikely that this would raise enough revenue to make any of these proposals truly revenue-neutral. President Obama's budget proposal includes measures to close loopholes in the estate tax, and the administration estimated that they would raise a total of just $23.8 billion over ten years.

Incredibly, Senators Lincoln and Kyl and others are now arguing that their proposal is necessary to protect jobs.

Despite the rhetoric used by these lawmakers, reducing the federal tax on the estates of millionaires has nothing to do with helping small businesses create jobs. This is true for several reasons.

1. Only a tiny number of small businesses would even be affected by the estate tax.

Late last year, the Tax Policy Center provided estimates that defined small business estates as those in which farm and business assets represent at least half of the gross estate and total no more than $5 million. Using this definition, it was estimated that only 100 farms and small business estates would have owed any estate tax this year if the 2009 rules had been in effect.[13]

2. Even those few affected by the estate tax already enjoy special breaks that make it more manageable for small businesses.

Even if Congress allowed the estate tax to revert entirely to the pre-Bush rules, there would still be plenty of provisions that make the estate tax manageable for closely held businesses and farms. Family farms receive an additional exemption and can be valued, for estate tax purposes, according to their "current use," which may be much less than they are really worth. Finally, the tax due on an estate that is a closely held business or farm can be paid over 14 years.[14]

3. It is very unlikely that the estate tax causes millionaires (the only people affected by it) to work less or invest less and therefore create fewer jobs.

Even for business owners wealthy enough to be affected by the estate tax, it's unclear how this tax could reduce their incentive to create jobs. The only way this could happen would be if the estate tax discouraged the wealthy from working or discouraged the wealthy from saving.

First, do estate taxes discourage work? If taxes of any sort really do discourage work then we would think that the estate tax discourages work less than most other taxes. After all, payroll and income taxes reduce the take-home pay of all working people, whereas estate taxes only affect the estates of millionaires after they die. Besides, it's more likely that the estate tax causes the children of rich parents to work *harder* since it reduces their inheritances.

Second, does the estate tax discourage people with millions of dollars from saving and investing it? For extremely wealthy people, the alternative to investing would be to consume millions upon millions of dollars. Wealthy people save and invest their money because there is little else to do with it. To truly escape the estate tax, a multi-millionaire could not save or invest money and could not spend it on houses or even fancy cars, which would all be included in the estate. It's difficult to imagine many multi-millionaires spending down their assets by traveling and partying in response to a tax that will have no effect until after they die.[15]

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[13]Tax Policy Center, "$3.5 Million Exemption and 45 Percent Rate: Distribution of Gross Estate and Net Estate Tax by Size of Gross Estate, 2010," November 18, 2009, http://www.taxpolicycenter.org/numbers/Content/PDF/T09-0440.pdf

[14]Citizens for Tax Justice, "Do Family Farms Need More Estate Tax Breaks? Pre-Bush Tax Rules Are Well Designed to Protect Farms," June 9, 2006. http://www.ctj.org/pdf/farm0606.pdf

[15]For a critique of research claiming to show an impact from the estate tax on investment, see Citizens for Tax Justice, "Caviar, Cruises, and Cocaine, Two New Studies from a Right-Wing Foundation Say the Estate Tax Causes the Rich to Stop Working and Spend Away Their Millions," June 12, 2009. http://www.ctj.org/pdf/afbfreportssummary.pdf

In other words, it's extremely unlikely that the federal tax on the estates of millionaires reduces work effort and investments by wealthy people, which in turn means it's extremely unlikely that the tax has any effect on job creation. If anything, the tax could help job creation because the revenue it raises can be used to fund services like highway construction and education that provide an economic benefit.

"Small Businesses" May Be a Trojan Horse for Tax Cuts for the Rich

As discussed here, some of the tax proposals that are being offered as help for small business job creation have nothing to do with small businesses or job creation. Lawmakers who have supported the Bush tax cuts in their entirety are going to continue to support making all of these tax cuts, even for the very richest Americans, permanent. They will use whatever argument they believe the public will be receptive to in the current economic and political environment.

This is nothing new. When George W. Bush took office amid a budget surplus, supporters of tax cuts insisted that the revenue had to be "given back" to the taxpayers. When those projected budget surpluses turned into budget deficits, supporters of tax cuts argued that tax cuts would improve the economy so much that they would pay for themselves (which, sadly, did not happen).[16] When the U.S. prepared to invade Iraq, House Republican Leader Tom DeLay even said that, "Nothing is more important in the face of war than cutting taxes."[17]

Budget surpluses, budget deficits, economic booms and economic busts, and even wars, all have been used as justifications for cutting taxes. Today the biggest concern Americans have is holding onto a job or finding a job, and many believe that helping small businesses is the answer. Sadly, some lawmakers are using "small business jobs" as their justification for handing more tax cuts to the very wealthiest and most powerful among us.

[16]Robert S. McIntyre, "Report Retort: The Bush Treasury Dismisses 'Supply-Side' Economics," The American Prospect Online, July 28, 2006. http://www.ctj.org/taxonomists/taxonomist20060728.pdf

[17]Paul Krugman, "The DeLay Principle," New York Times, June 9, 2006. http://select.nytimes.com/2006/06/09/opinion/09krugman.html?_r=1