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The Bush Tax Cuts and Small Business

Sometimes people accidentally say what they really mean. Bill Rys, spokesperson for the National Federation of Independent Business (NFIB) recently acknowledged to the Washington Post that President Obama's plan to let the top two income tax rates return to their pre-Bush levels would only affect a tiny fraction of small businesses. Rys went on to argue, however, that those are the largest firms and therefore the ones that are most likely to be hiring.¹

NFIB claims to represent all small businesses, but when it comes to its lobbying focus, it really represents only the largest ones. In fact, NFIB advocates almost entirely for the wealthiest business owners and Republican tax policies in general. It hides behind the image of struggling small businesses because it correctly thinks that most Americans will find that much more appealing.

NFIB is a key ally of Congressional Republicans and their friends on Wall Street in their campaign to make permanent the Bush tax cuts for the richest people. Any time that Republicans debate the fate of the Bush tax cuts, they talk about the small businesses who would allegedly be crushed under President Obama's tax plan.

President Obama proposes to allow the top two tax rates to go back to their pre-Bush levels, and to adjust the income tax brackets so that only married taxpayers with adjusted gross income (AGI) in excess of \$250,000 and unmarried taxpayers with AGI in excess of \$200,000 can be affected by the top two brackets. This will have little or no impact on any enterprise that can truly be called a "small business," despite claims to the contrary from NFIB.

This report explains five facts about small businesses and President Obama's tax plan:

1. Very few business people (3 to 5 percent) are rich enough to lose any portion of their tax cuts under Obama's plan.
2. Of the business owners who would pay higher taxes under Obama's plan, those with the very highest incomes cannot be called "small" business owners.
3. A person who receives their income from a business they own would have to receive over \$250,000 (or over \$200,000 if unmarried) in *net profits* in order to lose part of their tax cuts under President Obama's plan.
4. In order to hire people, business owners need customers, not tax cuts.
5. Claims that the richest 2.1 percent (who would lose some of their tax cuts under Obama's plan) account for a fourth of all consumer spending are *incorrect*.

¹Lori Montgomery and Michael D. Shear, "Small Businesses Emerge as Big Campaign Issue for Democrats and Republicans," Washington Post, July 29, 2010.

<http://www.washingtonpost.com/wp-dyn/content/article/2010/07/28/AR2010072806034.html>

1. Very few business people (3 to 5 percent) are rich enough to lose any portion of their tax cuts under Obama's plan.

Citizens for Tax Justice has calculated that only 2.1 percent of taxpayers will have AGI in excess of the \$250,000/\$200,000 threshold in 2011.² Even these taxpayers would continue to enjoy tax cuts on their income in the tax brackets below the top two tax brackets.

However, NFIB and Republicans in Congress have argued that Obama's plan poses a grave economic danger because a large number of small business owners who employ many people are among the richest 2.1 percent of taxpayers.

They are wrong. Citizens for Tax Justice has calculated that only 5 percent of taxpayers who rely on active business income for more than half of their income would be affected by the top two income tax rates under President Obama's proposal (meaning they would be rich enough to lose any portion of their income tax cuts under Obama's proposal).³ 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.⁴

2. Of the business owners who would pay higher taxes under Obama's plan, those with the highest incomes cannot be called "small" business owners.

Republicans in Congress echo NFIB's talking points by arguing that the very wealthiest business taxpayers are the ones who truly matter in the debate over taxes.

Former CBO director Douglas Holtz-Eakin, while testifying before the Senate Finance Committee, said that he thought the relevant figure was the amount of business income going to those few taxpayers rich enough to pay higher income taxes under the President's plan.⁵ The Joint Committee on Taxation (JCT) projects that next year taxpayers will report a trillion dollars of active business income, and about half of that will go to taxpayers who are in the top two brackets (the brackets for which President Obama and Democratic leaders propose to allow rates to go back up to pre-Bush levels).⁶

But the business taxpayers who are rich enough to pay higher taxes under Obama's plan (3 or

²Citizens for Tax Justice, "President Obama's Fiscal Year 2011 Budget: Federal Government Should Collect at Least as Much Revenue as Obama Proposes," February 10, 2010. <http://www.ctj.org/pdf/obamabudgetfy2011.pdf>

³Specifically, 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.

⁴Chuck 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

⁵Citizens for Tax Justice, "Douglas Holtz-Eakin Peddles Myths about the Bush Tax Cuts," July 16, 2010. <http://www.ctj.org/pdf/holtzeakin2010.pdf>

⁶Joint Committee on Taxation, "Present Law and the President's Fiscal Year 2011 Budget Proposals Related to Selected Individual Income Tax Provisions Scheduled to Expire under the Sunset Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001," July 12, 2010. JCX-36-10. <http://www.jct.gov/publications.html?func=startdown&id=3691>

5 percent, depending on which figure you use) can't all be called "small" business owners. They are merely people whose business profits are reported on their personal income tax forms. (This distinguishes these businesses from corporations that pay the corporate income tax.) But the businesses can be huge hedge funds, law firms, newspaper companies or even best-selling authors. They're not necessarily struggling and they are not necessarily the sort of business people who create very many jobs.

This becomes obvious when one considers data on total receipts of these "flow-through" businesses (so-called because the income is not taxed at the corporate level but at the individual level under the personal income tax), including S corporations, partnerships, and limited liability companies. Most of the total receipts from these businesses are generated by the small minority that have more than \$10 million in receipts.⁷ This is not to say that large companies are not an important consideration for policymakers. But it's important to note those business owners who actually would pay higher taxes under the President's proposal are not likely to be of the "mom and pop shop" variety.

In 2007 over 14,600 S corporations reported gross receipts in excess of \$50 million, and their 81,700 shareholders would report income from the S corporations on their individual returns.⁸ Surely, no one would reasonably think of these taxpayers as "small" business owners. For the same year, in the technical and professional category, 567 S corporation returns showed more than \$50 million in gross receipts, with the average gross receipts in that group being \$135 million.⁹

Six of the top ten lobbying firms are organized as partnerships (and three of the other four are private corporations that may be S corporations for tax purposes), as are most law, accounting, and engineering practices. Hedge fund and private equity firms are, too. This income is reported on the returns on individual taxpayers, but no serious person would call them "small" business owners.

⁷See Joint Committee on Taxation, "Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity," June 4, 2008, JCX-48-08. <http://www.jct.gov/publications.html?func=startdown&id=1291> The data show that only the top 2 percent of S corporations had total receipts in excess of \$10 million in 2005 and yet these few S corporations received 59 percent of the total receipts that went to S corporations. Similarly, only 1 percent of partnerships had total receipts in excess of \$10 million and yet these few partnerships received 80 percent of the total receipts that went to partnerships that year.

⁸Internal Revenue Service, "Returns of Active Corporations, Form 1120S, Table 6-S Corporation Returns: Total Receipts and Deductions, Portfolio Income, Rental Income, and Total Net Income, by Number of Shareholders, Tax Year 2007," <http://www.irs.gov/pub/irs-soi/07co06s.xls>

⁹Internal Revenue Service, "Returns of Active Corporations, Form 1120S, Table 7-S Corporation Returns: Balance Sheet and Income Statement Items, by Major Industry, Tax Year 2007." <http://www.irs.gov/pub/irs-soi/07co07s.xls>

3. A person who receives his income from a business he owns would have to receive over \$250,000 (or over \$200,000 if unmarried) in net profits in order to lose part of the tax cuts under President Obama's plan.

Imagine a small business person whose sole income is from the business she owns. Her business has gross receipts for the year of \$400,000 but her net profit is only \$50,000. Some mistakenly believe this person will pay higher taxes under President Obama's plan.

The income tax applies to income. If your income is from a business you own, your income consists of the net profits of that business. Net profits are what you have left after you've paid wages to your employees and you've paid your other expenses. The person in the example above would be nowhere near losing any portion of her tax cuts under President Obama's plan.

4. In order to hire people, business owners need customers, not tax cuts.

Businesses hire employees if there is a demand for the goods or services that the employees will produce. As explained above, a business person is not taxed on the money he or she pays to employees, because that is deducted and not included as part of taxable income. This means there is no reason why a higher income tax rate would reduce a business person's incentives to hire and create jobs.

Some have argued that business owners will be less likely to invest in equipment or other capital needed to expand a business and create jobs because capital purchases are made with after-tax money. But for small businesses, taxes are not what stands in the way of capital investments. If a small business owner wants to expand operations by purchasing new equipment, they typically benefit from small business "expensing." This means they pay no taxes on money used to purchase equipment.¹⁰

Another claim made by many Republicans in Congress is that businesses will not invest and hire people if they are uncertain about how much taxes they will have to pay in future years. This is a nonsensical argument, since not extending the Bush tax cuts for the rich will create at least as much certainty as extending them.

Businesses hire people if they believe that will result in profits for the business owners. It would be irrational to turn down a profitable opportunity just because your tax on the profit may be five percentage points higher.

For example, let's say that a small business person knows that after using all available tax breaks she can keep 80 percent of whatever additional profits are generated, and 20 percent will be paid in taxes. If the Bush tax cuts for the rich expire, and this business person is among the 2.1 percent who are rich enough to lose some part of their tax cuts, then perhaps she can only keep 75 percent of their profits from a new investment. If a promising investment

¹⁰Small 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.

opportunity presents itself, would she pass it up because she will only keep 75 percent of the profits, instead of 80 percent? That would be irrational.

It is quite rational, however, for business people to pass up opportunities to invest and hire more workers if there is little chance of profit because no one is buying whatever the business produces. For many businesses, that's the current, unhappy situation: a lack of customers. And income tax cuts for the rich won't solve that problem.

Wealthy people tend to save a much greater proportion of their income than low- and middle-income people. For this reason, the Congressional Budget Office (CBO) concluded that making permanent all the income tax cuts, including those for the richest taxpayers, was the least effective policy option for creating jobs.¹¹

Congress can and has taken measures to boost consumer demand by putting money in the hands of struggling families who *will* spend it right away. Unfortunately, Republicans in Congress did everything in their power to block these programs and even the "moderate" Republicans who voted for some of them caused them to be whittled down significantly.¹²

5. Claims that the richest 2.1 percent account for a fourth of all consumer spending are incorrect.

In the last couple months, a new rationale for extending the income tax cuts for the rich has appeared. Proponents of tax cuts for the rich decided that they agreed with us that what businesses really need is customers and that means that maintaining strong consumer demand is key to helping small businesses thrive. But they then claimed incorrectly that those few taxpayers rich enough to lose some portion of the Bush income tax cuts under Obama's plan make up 25 percent of consumer spending. So, they argued, tax cuts must be extended even for the very rich in order to avoid a significant drop off of consumer spending.

In fact, anti-tax voices pushing this argument were so persuasive that they got 31 House Democrats to sign a letter citing this 25 percent figure and calling for an extension of the income tax cuts even for the very rich.¹³

The assertion that the richest 2.1 percent of taxpayers account for 25 percent of consumer

¹¹Congressional 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>.

¹²For example, the American Recovery and Reinvestment Act of 2009 (ARRA) passed without a single Republican vote in the House, and three Senate Republicans voted in favor only after negotiating down the overall cost of the legislation and ensuring that a significant part of the overall cost would be devoted to relief from the Alternative Minimum Tax (AMT). Relief from the AMT is something Congress enacts every year and it provides almost no benefit to the poorest three fifths of taxpayers, making it a very poor economic stimulus. See Citizens for Tax Justice, "Poorest 60% of Taxpayers Get No Benefit from Reduction in Alternative Minimum Tax Included in Senate Stimulus Bill." February 11, 2009. <http://www.ctj.org/pdf/amtpatchisnotstimulus.pdf>

¹³A report from CTJ even found that most of members signing this letter were from districts that had a lower than average number of rich constituents. See Citizens for Tax Justice, "Most House Democrats Supporting Tax Cuts for the Rich Have Lower than Average Percentage of High-Income Households in Their Districts," September 21, 2010. <http://www.ctj.org/pdf/letterwith31.pdf>

spending is not just wrong; it is impossible. In 2011, the richest 2.1 percent of taxpayers will account for about 21 percent of total pretax cash income. But their share of total personal consumption is certainly not higher than their share of total income. In fact, it is considerably lower, because they save a much higher portion of their after-tax income than less well-off Americans.

We estimate that the 2.1 percent of taxpayers who are rich enough to lose part of their Bush tax cuts under the Obama plan are responsible for only about 8 percent of total national consumer spending.