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Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

To: Members, Subcommittee on Economic Growth, Tax and Capital Access

From: Professional Staff

Date: September 10, 2012

Re: Hearing: "Adding to Uncertainty: Small Businesses' Perspectives on the Tax Cliff"

The Subcommittee on Economic Growth, Tax and Capital Access of the Committee on Small Business will meet for a hearing titled, "Adding to Uncertainty: Small Businesses' Perspectives on the Tax Cliff." The hearing will take place at 10:00 a.m. on Thursday, September 13, 2012 in Room 2360 of the Rayburn House Office Building. The purpose of the hearing is to learn small businesses' views on the December 31, 2012 expiration of the 2001 and 2003 tax cuts and the policy implications of the respective positions of the Obama Administration and congressional Republicans on a tax cut extension.

I. Introduction

Most businesses in the United States are considered small,[1] and the vast majority of these small businesses are organized as pass-through entities, which pay taxes at individual rates.[2] Overall, pass-through businesses account for 44 percent of all business income and employ approximately 54 percent of the private sector workforce.[3] In terms of small businesses, approximately 71 percent of small employer firms are organized as pass-through entities.[4]

Given the importance of small businesses to the United States economy, and the number of small businesses which operate as pass-through entities, the memorandum will discuss some of the potential policy implications of an expiration of the marginal income tax rate relief contained in the 2001 and 2003 tax cuts, including proposals to allow these cuts to expire for certain high- income

[1] UNITED STATES SMALL BUSINESS ADMINISTRATION, OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS (Sept. 2012) (hereinafter "SBA Advocacy FAQ"), *available at* http://www.sba.gov/sites/default/files/FINAL%20FAQ%202012%20Sept%202012%20web.pdf.
[2] ROBERT CARROLL & GERALD PRANTE, ERNST & YOUNG, THE FLOW-THROUGH BUSINESS SECTOR AND TAX REFORM i (April 2011) (hereinafter "Ersnt & Young Pass-Through Study"), *available at* http://www.s-corp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf. The terms pass-through and flow-through are used interchangeably in the literature dealing with taxation of business entities. The memorandum adopts the "pass-through" term. The most common forms of pass-through entities are sole proprietorships, partnerships, and Subchapter S corporations.
[3] Robert Carroll & Gerald Prante, ERNST & YOUNG, LONG-RUN MACROECONOMIC IMPACT OF INCREASING TAX RATES ON HIGH-INCOME TAXPAYERS IN 2013 i (July 2012) (hereinafter "Small Business Tax Study"), *available at* http://www.icba.org/files/ICBASites/PDFs/taxstudy.pdf.
[4] SBA Advocacy FAQ, *supra* note 1 at 4.

earners. In order to help answer these questions, it is first necessary to understand how most small businesses are organized and how they pay their taxes.

II. Small Business Taxation: Individual Versus Corporate

Approximately 95 percent of businesses are organized as pass-through entities,[5] meaning that the business's income is passed through to the individual owners who pay the taxes at individual rates, and the entity (business) does not pay taxes.[6] While not all pass-through entities are small businesses, private sector employment within the pass-through sector is more concentrated among smaller firms than C corporations.[7] For example, the Ernst & Young Pass-Through Study found that 87 percent of pass-through entities employ fewer than 500 workers, and are thus small.[8] In addition, a number of associations representing small businesses claim a substantial number of their members are organized as pass-through entities. One survey conducted by the National Federation of Independent Business found that 75 percent of small businesses are organized as pass-through entities.[9]

As most businesses in the United States are considered small, and most are organized as pass-through entities, a key consideration for the Committee is what higher marginal income tax rates mean for small pass-through businesses, particularly how higher rates influence small business decision making behavior, increase the cost of capital and possible macroeconomic considerations. It is to these issues that the memorandum now turns.

III. Background on the 2001 and 2003 Tax Cuts

In 2001 and 2003, the Congress enacted legislation that resulted in significant reductions in certain statutory tax rates. The 2001 law, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA),[10] gradually reduced marginal income tax rates,[11] eliminated the so-called marriage penalty tax,[12] gradually reduced and then eliminated the estate tax,[13] and reduced and then eliminated overall limits on itemized deductions[14] and the personal exemption phase-out, among other provisions.

Many of the tax provisions in the EGTRRA were scheduled to phase in over time. To accelerate this process, Congress enacted in 2003 the Jobs and Economic Growth Tax Relief Reconciliation

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[5] *Id.*
[6] This contrasts with businesses organized as corporations that pay taxes as an entity separate from taxes paid by the corporation's shareholders. Pass-Through Study, *supra* note 2 at 2.
[7] *Id.* at 4.
[8] *Id.* Classifying a business as small based on its employing 500 or fewer workers is a widely utilized, yet imprecise, metric. To determine whether a particular business in an industry meets the small business definition, the Committee refers to the regulations of the United States Small Business Administration, 13 C.F.R. § 121.201, which is also available at http://www.sba.gov/sites/default/files/files/Size_Standards_Table.pdf. Those standards vary depending on the type of business and are not classified by the form of the business.
[9] http://www.nfib.com/advocacy/item/cmsid/54685.
[10] Pub. L. No. 107-16, 115 Stat. 38 (2001).
[11] *Id.* at § 101, 115 Stat. at 41.
[12] *Id.* at §§ 301-03, 115 Stat. at 55-57.
[13] *Id.* at §§ 501-21, 115 Stat. at 69-72.
[14] *Id.* at §§ 102-03, 115 Stat. at 44-45.

Act (JEGTRRA).[15] In addition to accelerating the phase-in of marginal rate reductions,[16] the law also reduced tax rates on long-term capital gains and dividends,[17] among other provisions.

However, none of the changes in tax law resulting from EGTRRA and JEGTRRA were permanent. The EGTRRA and JGTRRA laws were enacted under the reconciliation process[18] and became subject to the Byrd Rule.[19] The Byrd Rule limits matters that can be considered under reconciliation in the Senate. This necessitated a sunset provision that would revert tax rates to previous law unless they were specifically extended or made permanent by Congress.[20]

Presently, the 2001 and 2003 tax cuts are scheduled to expire on December 31, 2012. No one contends that it would be appropriate to allow tax rates to revert to their pre-2001 levels. Such a result would have negative consequences on the economy. However, there are disputes as to whether extending all the tax cuts are appropriate. Factors that should be considered include the impact on the economy and small businesses, specifically.[21]

President Obama has proposed that the top two marginal tax rates expire, thus increasing these rates from 33 percent and 35 percent to 36 percent and 39.9 percent, for individuals with incomes at or above $200,000 a year ($250,000 if filing jointly) with these additional revenues being used for the purpose of deficit reduction. In addition, the Obama Administration's proposal would limit the applicability of the Personal Exemption Phase-Out[22] and the Pease limitations[23] for taxpayers with incomes above these thresholds. Congressional Republicans generally support a complete extension of all expiring tax provisions from 2001 and 2003. While acknowledging the deficit is a significant concern, Republicans generally favor reductions in government spending to reduce budget deficits rather than increasing taxes. The memorandum will now discuss the potential implications of these policies.

IV. Possible Implications of Extending Lower or Increasing Marginal Rates on Small Pass-Through Entities

Given the importance of small businesses as job generators, it makes sense to assess the effects of terminating the 2001 and 2003 tax cuts on businesses organized as pass-through entities. Therefore, it is important to know the number of small businesses subject to higher marginal income tax rates, whether the small business has employees, the influence of tax rates on their decision making, and the possible macroeconomic implications of the tax increase.

[15] Pub. L. No. 108-27, 117 Stat. 752 (2003).
[16] *Id.* at §§ 101-05, 117 Stat. at 753-55.
[17] *Id.* at §§ 301-03, 117 Stat. at 758-64.
[18] Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 310, 88 Stat. 297, 315, codified at 2 U.S.C. § 641.
[19] *Id.* at § 313, codified at 2 U.S.C. § 644. The Byrd Rule limits the use of reconciliation on non-deficit reduction measures that may increase spending or decrease revenues outside the 10-year budget window.
[20] The rate reductions and other changes in EGTRRA were originally scheduled to expire on December 31, 2010, while those in JGTRRA were originally scheduled to expire on December 31, 2008. However, Congress subsequently enacted extensions of these laws, albeit with certain modifications.
[21] The emphasis on small business is relevant because small businesses generate most new jobs in the economy.
[22] The Personal Exemption Phase-out reduces the value of personal exemptions for certain high-income taxpayers.
[23] The Pease limitation was named for its sponsor, former Representative Donald Pease, and limits the number of itemized deductions certain high-income taxpayers may claim.

a. Number and Composition of Small Pass-Through Businesses Affected by Higher Marginal Rates

The Administration contends that its proposal to allow taxes to increase for taxpayers with income over $200,000 a year ($250,000 if filing jointly) would apply to only 3.5 percent of small businesses owners.[24] However, given the large aggregate number of small pass-through businesses, the same data demonstrates that approximately 940,000 owners of small businesses nationwide would see a tax increase under the Obama Administration extension proposal.[25]

In addition, opponents of the Administration's extension proposal note that the that 3.5 percent of small businesses figure is misleading because it is an aggregate figure and does not take into account the composition of small businesses. The calculation gives equal weight to businesses in which the owner is the only employee versus a small business that may have a substantial number of employees, when clearly the latter is more significant in judging overall economic impact and job implications. According to a National Federation of Independent Business survey, those businesses most likely to experience a tax increase under the President's extension proposal are those employing between 20 and 250 employees.[26]

b. Higher Marginal Income Tax Rates and Small Business Decision Making

Another consideration is how individual tax rates can influence various economic decisions of pass-through business owners, including decisions on making new investments or hiring additional workers.[27] Research suggests that small businesses are more likely to undertake new investment or hire additional workers when marginal tax rates are low, compared to when they increase.[28] In contradistinction, other research shows that higher tax rates have only a weak association with small business hiring decisions and may even spur an increase in entrepreneurial activity by individuals.[29]

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[24] See e.g., Memorandum from Thomas A. Barthold, Staff Director, Joint Committee on Taxation, United States Congress, to redacted recipients (June 18, 2012), available at http://waysandmeans.house.gov/uploadedfiles/jct_memo_on_impact_of_tax_hikes_on_flow-through_businesses_061812.pdf.

[25] *Id.*

[26] Letter from Susan Eckerly, National Federation of Independent Business (September 9, 2011), *available at* http://www.nfib.com/advocacy/item/cmsid/54685.

[27] Ernst & Young Pass-Through Study, *supra* note 2 at 7.

[28] *Id.* at 7.

[29] Thomas A. Garrett and Howard J. Wall, RESEARCH DIVISION, FEDERAL RESERVE BANK OF ST. LOUIS, CREATING A POLICY ENVIRONMENT FOR ENTREPRENEURS 14 (September 2005), available at http://research.stlouisfed.org/wp/2005/2005-064.pdf. In explaining the higher rates of entrepreneurial activity in high tax states, the authors noted that self-employment presents additional opportunities for tax avoidance and that this effect may explain high entrepreneurial activity in high income tax states. *Id.* at 4 and 14.

c. Small Pass-Through Businesses' Cost of Capital

Others contend that higher marginal income tax rates could increase the cost of capital accumulation for small businesses.[30] They note that reported income and actual income that small businesses have at their disposal is often distinct.[31] For example, income could be retained in the business instead of being passed onto its owners. These retained earnings could be subject to higher marginal income tax rates, leaving less for capital accumulation. In this instance, any new investment requires a higher potential rate of return due to the increased cost of capital imposed by higher marginal rates.

d. Possible Macroeconomic Implications in Extending Existing or Raising Marginal Tax Rates

Finally, lawmakers and small businesses may be concerned about the potential macroeconomic implications of the Administration's extension proposal. In the short-term, some have estimated that the propoed tax increase would reduce economic output equal to the current rate of economic growth.[32] Another study determined overall Gross Domestic Product would decline by $200 billion and long-run employment would decline by 710,000 jobs.[33]

Others note that high annual budget deficits are a significant macroeconomic policy concern. Long-term deficits may require the government to borrow more money, thereby forcing the cost of capital to businesses to rise as interest rates go up. Furthermore, long-term deficits may force businesses to reduce investment given uncertainty over higher taxes or interest rates. Without a concomitant reduction in spending, maintenance of the 2001 and 2003 tax cuts may increase the deficit.

V. Conclusion

The looming expiration of the 2001 and 2003 tax cuts presents several challenges for small businesses and lawmakers. Presently, an increase in marginal income tax rates on small businesses could result in many small businesses having less income for operations and investment and could result in less overall economic output, thus further constraining already weak economic growth and job creation. At the same time, persistently high budget deficits may be substituting short-term economic growth and output for long-term economic growth and output. Sooner or later, the federal government will need to address the long-term implications of budget deficits to the economy, the solution to which may include policies such as large reductions in government spending, higher taxation, or a combination of the two that could supplant short-term growth for long-term growth.

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[30] Douglas Holtz-Eakin & Ike Brannon, AMERICAN ACTION FORUM, THE TAXATION OF SMALL BUSINESS: PASS-THROUGH ENTITIES 3 (July 1, 2012), *available at* http://americanactionforum.org/sites/default/files/Pass%20Throughs.pdf.

[31] *Id.*

[32] *Id.* at 1.

[33] SMALL BUSINESS TAX STUDY, *supra* note 3 at 4. It is important to note that the above estimate takes into consideration the effects of additional taxes that are part of the Patient Protection and Affordable Care Act.