

Small Business Nonsense

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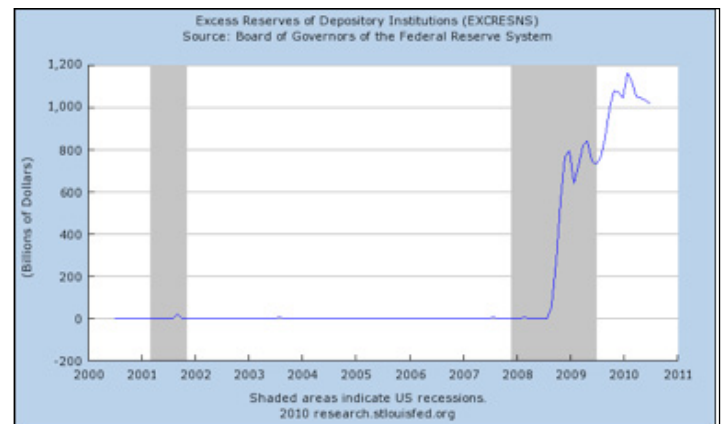
Last week, President Obama identified a “small business jobs bill” as the first item Congress should act on in September. He suggested “small businesses have put hiring and expanding on hold while waiting for the Senate to act on this bill.” Passage of the legislation has almost been presented as a necessary condition for economic recovery. On Wednesday, the President is expected to propose some new tax breaks for small business that he presumably will want added to this small business measure.

(Early reports indicate that the President will propose accelerating the write-off schedule for certain business investments and expanding the research and development tax credit. See e21’s quick analysis of the R&D proposal here.)

The current small business bill that’s pending before Congress (and that’s being touted by the President) would do two things: create a new Small Business Lending Fund and enact new tax exclusions and deductions for small businesses. The new lending fund is modeled after the TARP equity purchase program: the Treasury would buy the preferred stock of certain small banks with the dividend rate on that investment calibrated based on the bank’s small business lending portfolio. The tax provisions would largely build on existing tax policy by expanding certain deductions and exclusions and making others more generous.

Viewed in the overall context of the Obama Administration agenda, the provisions in the bill are trifling. The day after the President’s speech last week, the *Wall Street Journal* published a letter to the editor from a small business owner in

Massachusetts who argued that the best policy towards small business would be lower taxes, less regulation, and a reduction in “irrational” government spending. The author ridiculed the notion that new loan programs would create incentives to create jobs and dismissed targeted tax provisions as “gimmicks” that lack the “dynamic impact of an across-the-board tax reduction.” Needless to say, the small business owner thought the marginal value of the small business bill was next to zero, while the rest of the President’s agenda was hugely damaging to small businesses.



The data support this impression. First, the proposed small business lending fund does not make much sense given the volume of excess reserves currently in the banking system (see graph). According to the Fed, commercial banks currently hold over \$1 trillion in excess cash reserves, which are cash balances over and above those required by regulation. Banks would rather hold these funds on balance with the Fed and earn 0.25% annualized interest than lend to businesses in the current environment. According to a recent Bloomberg story, Small Business Association



(SBA) loans have a default rate that's 50% higher than those of junk bonds. Others put the net loss rate on small business loans between 4% and 14%. Banks cannot afford to add exposure to such credit risk in the current environment. Creating a new TARP-program to force banks to lend to marginal credits would do nothing to bolster long-run growth if the capital is misallocated to businesses that would have not otherwise received the funds and go on to fail. (Click here to read more about how this loan program could cost taxpayers money in the long-term.)

The expansion of tax preferences for small businesses is also unlikely to have a material impact on growth. The most touted provision is an expansion of Sec. 1202 of the tax code, which lets taxpayers exclude capital gains on stock in certain small businesses. The proposal would increase the exclusion from 75% to 100%, so that the effective rate on small business investment would be 0% on the first \$10 million of gain or 10 times the stock's adjusted basis, whichever is less. Eliminating capital gains on small business sounds like a good idea, but the practical obstacles to claiming the tax preference are so great that Sec. 1202 has thus far been an abject failure. To avoid abuse, the provision limits qualifying small business stock to businesses in certain approved industries, places limitations on mergers or joint investments, and excludes any subsequent investments from the special tax rate once the business' gross assets exceed \$50 million. In the words of one tax expert, anti-abuse rules "make the incentive look more risky than the investment itself." Any number of actions on the part of the business or the taxpayer could jeopardize the incentive. Even the \$50 million threshold – which has the most intuitive appeal of the restrictions since it limits the incentive to small business – eliminates many businesses in the biotech or information

technology sectors that have patents with a fair market value of \$50 million. This tax provision is likely pure windfall with no marginal investment incentive: the risk of forfeiting the tax incentive is so great that any investment made in a qualifying small business would have likely been made anyway.

Contrast this provision with the Obama Administration's proposal to increase individual income taxes. More than 27 million businesses pay taxes at the individual level. Rather than being subjected to an entity-level tax, the income generated by these businesses is distributed to their owners and included in individual gross income. The effective individual income tax rate of small business owners is therefore the rate at which small business income is taxed. According to the Treasury Department, small business income is concentrated in the top two tax brackets, with the brackets impacted by the proposed Obama receiving over 70% of flow-through income and paying more than 80% of the taxes on this income (the data are likely similar for closely-held C corporations).

Does anyone really believe that the pending small business bill would provide benefits with an economic value that even approaches the costs associated with increasing taxes on 70% of small business income?

Table 3.3: Flow-through Income and Individual Income Taxes, 2006

	Taxpayers with Flow-through Income/loss		Flow-through Income/Loss 1/		Tax on Flow-through Income/loss	
	millions	%	\$billions	%	\$billions	%
All Flow-through income						
All taxpayers	27.5	100%	938	100%	159	100%
Taxpayers in:						
Top 2 tax brackets	2.1	8%	671	72%	131	82%
Top tax bracket	1	4%	573	61%	113	71%
Active, positive flow-through income						
All taxpayers	18.3	100%	762	100%	145	100%
Taxpayers in:						
Top 2 tax brackets	1.4	7%	433	57%	109	75%
Top tax bracket	0.7	4%	349	46%	92	64%
Flow-through income > 50% wages						
All taxpayers	11.9	100%	880	100%	156	100%
Taxpayers in:						
Top 2 tax brackets	1.1	9%	608	69%	127	81%
Top tax bracket	0.6	5%	527	60%	110	70%



Many progressives wish to dispute these findings, arguing that “most” small businesses owners don’t pay taxes at the top individual rates. As the table above shows, that’s true; only about 8% of small business owners are in the top 2 brackets. But this is a non sequitur. Of course “most” small businesses don’t pay taxes at the top individual income tax rates; most small businesses fail within the first five years of existence, while many others break-even but fail to generate net income to distribute to owners. And, as Kevin Hassett and John Viard point out, the IRS defines small business owner as anyone who reports flow-through income on their tax return, which includes people who make money selling goods on eBay. Who cares about the tax rate applied to income that does not exist? Focusing on the tax rates of businesses that don’t generate taxable income on which to pay taxes is a ruse that distracts from the proposed tax increase on 70% of flow-through business income. Some left-leaning analysts, like tax economist Joel Slemrod have also argued against small business tax preferences largely because the bulk of small business income is reported by taxpayers at the top of the income distribution.

The other argument often used is that the small business income flows through to passive owners who have no role in the business. As shown in the table above, among taxpayers whose small business income accounted for at least 50% of wages, 9% were in the top brackets, receiving 69% of the income and paying 81% of the taxes. Moreover, raising taxes on “passive owners” seems a bit odd, as the tax rate on such income impacts the willingness of these investors to provide capital to the entrepreneurial owners. Maybe a limited partner in a small machine tools company is a lawyer who earns \$500,000 in compensation from her law firm. If you raise her taxes by 13% on any income distributed from

machine tools company, the investment becomes a lot less attractive relative to investing instead in the stock market or just spending the money. The economic cost of the increased taxes on the flow-through income of these investors in and of itself would be several orders of magnitude greater than the tax provisions contained in the small business bill.

Beyond increasing taxes on business owners at the individual level, the Obama Administration’s tax reform panel recently suggested imposing corporate income taxes on noncorporate businesses. The tax reform panel proposes expanding the corporate tax base by requiring some of the 27 million flow-through businesses to pay the corporate income tax. The proposal would establish certain income or asset thresholds and require all businesses that exceed them to pay the corporate tax, irrespective of organizational form. Consider the impact on \$100 of small business income paid to owners in the top tax bracket: instead of paying \$35 of taxes, as today, the owners would first pay \$35 in corporate taxes before being assessed an additional \$28 in taxes on the income distributed from the business (assuming the dividend tax rate expires as under current law and the health care law’s tax surcharge takes effect). The effective tax rate on small business income in this example would rise to more than 63%.

Finally, it is also important to note that these are not the only tax provisions impacting small business. The tax increase on “carried interest” that passed the House would also raise taxes on the sale of many small businesses. To guard against tax planning by investment fund managers to avoid the tax increase, the bill would deny capital gains tax treatment on the sales of partnership interests by owners that provide certain services to businesses. But given the ubiquity of the partnership organizational form



– more than 3 million businesses owned by over 18 million partners – this anti-abuse provision could expose trillions of dollars in business equity to higher tax rates. Research by tax advisors at KPMG explores the breadth of the potential tax increase and highlights how the sale of small businesses owned by partnerships would be denied capital gains treatment.

Perhaps the Wall Street Journal summarized best how many small businesses are evaluating this jobs bill: "The tax cut in this bill will provide \$12 billion in relief over 10 years. The tax increase that Mr. Obama favors for 2011 would raise what the Joint Committee on Taxation figures will be \$600 billion of revenues, about half of which comes from the coffers of small business. So the tax hikes, which are permanent, are about 50 times larger than the tax cuts, which are temporary." If Congress truly cares about the fortunes of America's small businesses, it would disregard the current bill and pass an extension of the expiring individual income tax rates.