

10-10-08 Summary of Senator Grassley's Floor Speech Comparing Senator McCain's and Obama's Tax Plans Effects on Small Businesses

On September 11, 2008, Senator Grassley delivered a floor speech on Senator McCain's and Senator Obama's tax plans effects on small businesses. The text of the speech and charts used in the speech are available at <http://finance.senate.gov/press/Gpress/2008/prg091108.pdf>. The speech makes the following points:

1. Federal small business policy generally defines a small business a non-publicly-traded entity employing 500 or fewer workers.
2. Small businesses are an extremely important dynamic part of the U.S. economy, including the source of all net new jobs for 2006 (last year available).
3. Small business income is attributable to the small business owner and taxed at his or her rate.
4. Senator McCain proposes to leave the marginal rates applicable to small business owners at current law levels.
5. Senator Obama proposes to raise the top two marginal rates from 33% and 35% to 40% and 41% respectively (when PEP and Pease reinstatement are considered).
6. Senator Obama also proposes to raise the top rate on capital gains and dividends from 15% to 20% (so, regular "C" corporation small business owners would be affected on any dividends or capital gains they receive from their investments.)
7. Senator Obama's marginal rate increase would mean a 17% to 33% increase on small business owners in the top two brackets.
8. Proponents of the marginal rate increase seek to minimize its impact by referring to Tax Policy Center ("TPC") data that indicate 1.9% of small business filers lie in the top two brackets; the argument is that a minimal amount of small business activity is affected.
9. There are two faulty assumptions to the small filer argument.
10. The first faulty assumption is that the percentage of filer businesses is static; in fact, small businesses move in and out of gain and loss status depending on the nature of the business and business cycle. For example, Treasury data show that, for flow-through businesses, 7% to 9% of small business owners pay the top two marginal rates.
11. The second faulty assumption is that the level of small business activity, including employment is proportionate, to the filer percentage. According to NFIB survey data, 50% of owners of small businesses that employ 20-249 workers would fall in the top two brackets. Over half of the nation's private sector workers are employed by small businesses with 20-500 employees.
12. If the proponents of the marginal increase on small business owners agree that a 17% -- 33% tax increase is not wise, then they should present data that show a different result.

10-10-08

Questions and Answers on the effect of the proposed top two marginal rate increases on small businesses (Senator Grassley's September 11, 2008 floor speech. It is available at <http://finance.senate.gov/press/Gpress/2008/prg091108.pdf>)

Question #1: What is a small business?

Answer #1: SBA says non-publicly-traded entity with 500 or fewer employees.

Question #2: What role does small business play in the national economy?

Answer #2: SBA says small business creates 60-80% of jobs. Treasury says small business accounts for 95% of businesses, 46% of business receipts, 47% of wages paid, and 52 percent of net business income. (This is both flow-throughs and small C corporations).

Question #3: How are small businesses taxed?

Answer #3: Small business owner pays the tax at their individual marginal rate levels (even in small C corporation context, they will bear the tax on salary, dividends, or capital gains).

Question #4: How would small business tax rates change under Senator McCain's and Senator Obama's plans?

Answer #4: Currently, the top two rates are 33% and 35%. Senator McCain wants to retain those rates. Senator Obama wants to raise those rates to 40% and 41% respectively (when the PEP and "PEASE" hidden rates are reinstated). For those small businesses in the top two brackets, Senator Obama's plan would raise the marginal rates by 17% to 33%. The 33% comes from raising the top capital gains and dividends rate from 15% to 20% on distributions from small C corporations.

Question #5: How do proponents of raising the top two marginal rates describe the effect of raising the top two marginal rates on small business activity?

Answer #5: Proponents of this change describe effect as minimal. They cite the Tax Policy Center ("TPC") analysis of July 14, 2008. The analysis concludes that 1.9% of "tax units" with small business income pay the top two marginal rates. They concede that, under TPC analysis, this percentage is three times the percentage of tax units that pay the top two marginal rates in the general population of tax units, i.e. .6%. For the proponents, the small percentage of small business tax units means the small business taxpayers are no different than the general tax unit population. The proponents' primary tax policy goal is enhancing the tax system's progressivity. Since, by this proportionate filing status test, the tax profile of small business tax units is not materially different from the general tax unit population, progressivity goals are met without any other uniquely negative economic effects.

Question #6: Do opponents of raising the top marginal rates agree with the TPC statistic?

Answer #6: Yes, the TPC model, under its terms, correctly calculates the tax unit filing percentages.

Question #7: If the TPC model is correct, do you agree with the proponents that the small business impact is minimal?

Answer #7: No. The TPC distribution analysis shows that a disproportionate share of small business income concentrated in the top two rates. For instance, for 35% bracket taxpayers, 38.8% of their income is business income. For 33% bracket taxpayers, 31.6% of their income is business income. What's more, Treasury data for 2006, show many more taxpayers affected. For pass-through entities, Treasury calculates between 7% and 9% of small business taxpayers pay the top two marginal rates. These taxpayers account for between 57% and 72% of flow-through business income and between 75% and 82% of taxes. Note that any distribution table is only a snapshot and ignores income mobility. Small business income moves up and down as well. As evidence of the volatility of small business income, take a look at the survival rates for small business. For instance, only 44% of small businesses survive for at least 4 years.

Question #8: O.k., let's say the proponents of raising the top two rates concede proportionately more small business income is concentrated in the top two rates. If more progressivity is their goal and these small business owners are better off than most of the population, then what harm could outweigh more progressivity?

Answer #8: Small business owners have the choice to make further investments in their businesses in the form of capital contributions or retained earnings. Moreover, in the small business context, creditors usually look to the owners for ultimate payment (through guarantees and the like). So, the owner's disposition vis-a-vis other uses of the owner's money determine, in part, the future capitalization of the business. If the after-tax rate of return on the investment in the business drops, the business becomes a less attractive investment. If the relative after-tax rates of return on other investment choices rise significantly, then the owner is likely to shift money out of the business and into other more tax-favored investments. Senator Obama is willing to risk this shift of capital out of small business in exchange for more progressivity. Senator McCain does not want to encourage this shift of capital out of small business.

Question #9: Give me an example of how the top two marginal rates would affect the small business owner's investment?

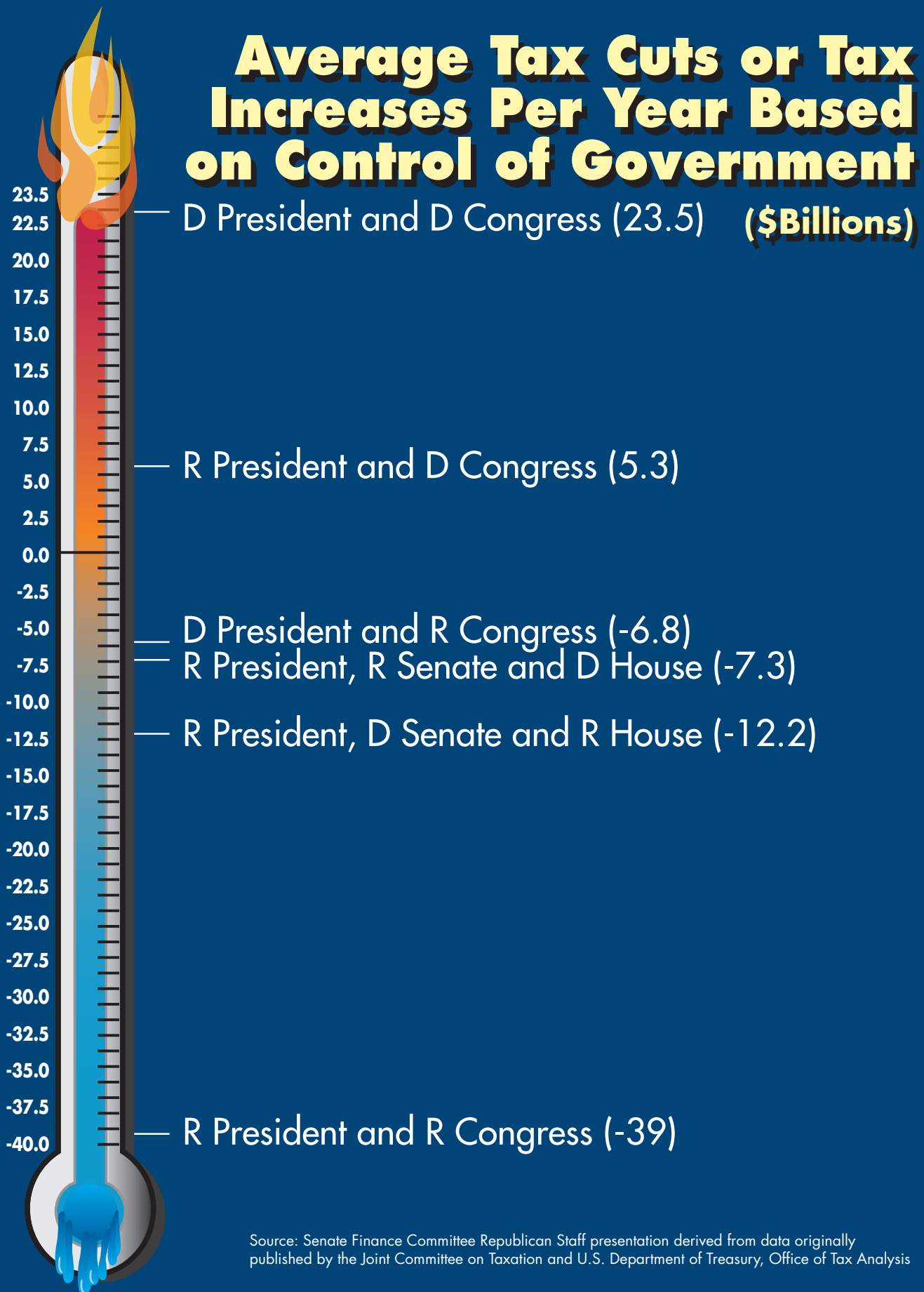
Answer #9: Owner of small business is married with two children. Owner's small business has a good year and earns \$500,000. Under current law, the small business owner pays \$146,700 in Federal income tax. That's where Senator McCain wants to keep the level of taxation on this small business. Senator Obama would raise the small business owner's taxes by \$20,000. (Note: this calculation includes PEP and Pease effects). Senator Obama's plan would raise the small business owner's taxes by 13%. Absent new unexpected income, the small business owner would have to cut costs by \$20,000 out of labor, materials, rent, etc. Moreover, since this added tax burden would permanently reduce the business' after-tax rate of return, it would affect the owner's future plans with respect to the small business.

Question #10: O.k. So, the proponents of the rate hikes may agree that some wealthier small business owners might be adversely affected, it's still only 2% of tax units according to TPC. Perhaps the proponents even agree with the larger Treasury number. In that case, we're still talking about less than 10% of small businesses that file returns. The impact can't be very much, right?

Answer#10: Wrong. The affected business activity and workers are not proportionate to the percentage of filers or tax units. That's the key flaw in the proponent's argument. NFIB performs surveys of small business owners. According to NFIB's latest financial survey, taxpayers above \$250,000 in income account for significant ownership of small businesses.

For firms with 1-9 workers, the ownership percentage is 6.4%; for firms with 10-19 workers, the ownership percentage is 21%; for firms with 20-249 employees, 40% of owners earn \$250,000 or more. Since Sen. Obama's advisors have said singles above \$200,000 are targeted for tax increases, it is fair to look at survey data for them as well. If all taxpayers above \$200,000 are included, then, for firms with 1-9 workers, the percentage owned is 12%; for firms with 10-19 workers, the percentage owned is 27%, and for firms with 20-249, the percentage is 50%. NFIB doesn't have data for firms employing between 250 and 500 workers, but the trend of the data make it clear that you could count on at least 50% of the ownership of those firms being taxpayers targeted by Senator Obama for a marginal rate increase of between 17% and 33%. The SBA's report to the President for 2007 analyzed small business data for 2006. According to that report, all net private sector job creation occurred in the population of businesses, Senator Obama is targeting for a tax increase. Over half of the nation's private sector employees work in that group of businesses. Over one-half of the nation's private sector GDP was produced in that group of businesses. What's more take the word of the small business community itself. (Reference the NFIB, SBLC, and SSC 3-14-03 letter).

Average Tax Cuts or Tax Increases Per Year Based on Control of Government



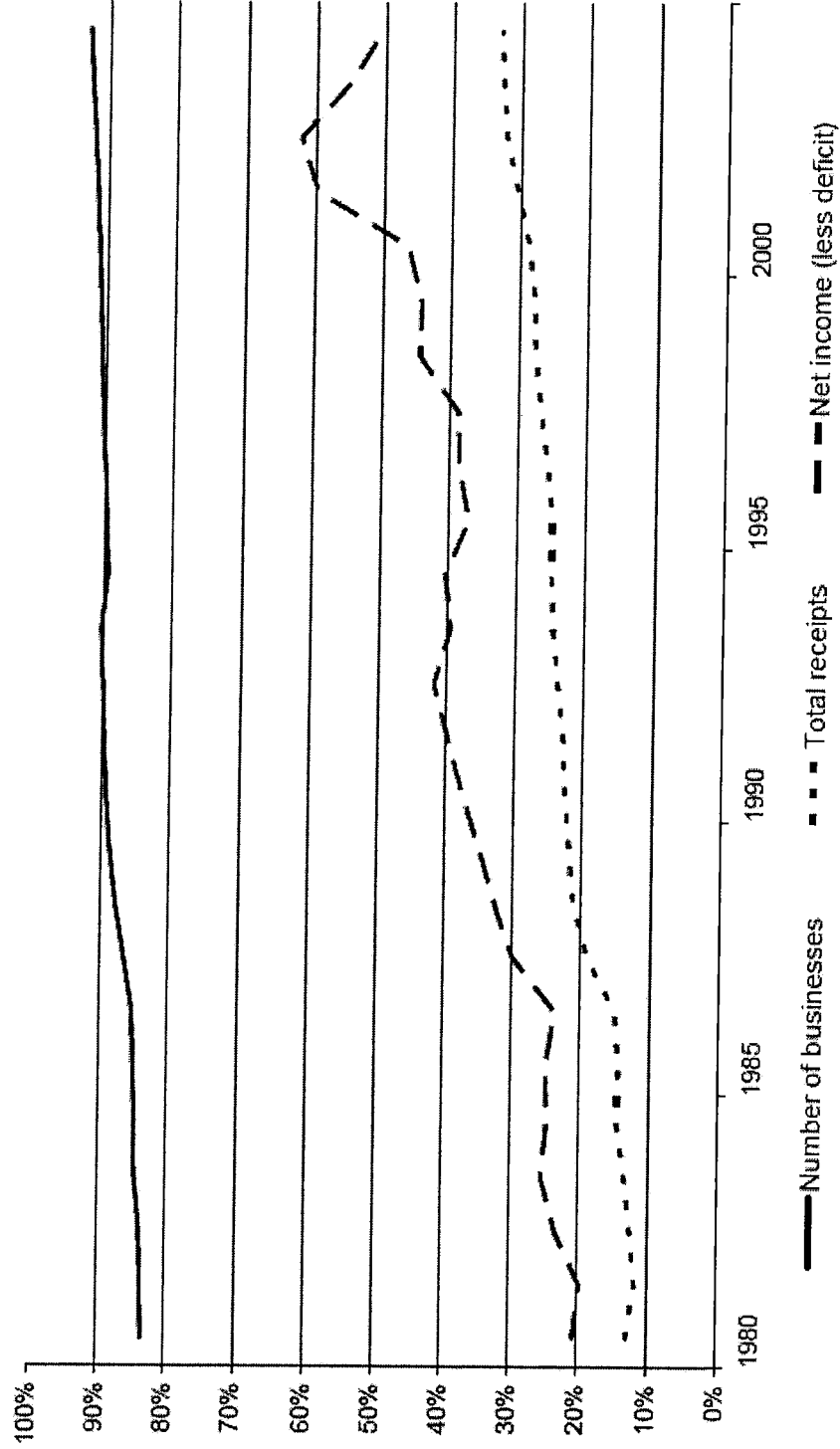
Source: Senate Finance Committee Republican Staff presentation derived from data originally published by the Joint Committee on Taxation and U.S. Department of Treasury, Office of Tax Analysis

Tax Hike Amnesia



1992 Campaign	N	1993 Legislation
	O	
Middle Class Tax Cut Promised	V	Largest Tax Increase Enacted
	3, 1992	

Chart 3.1: Flow-through Shares of All Business Returns, Receipts, and Net Income, 1980-2004



Source: Internal Revenue Service, Statistics of Income, www.irs.gov/taxstats.

Contributions to Business Activity by Type of Entity, 2004

<u>Selected items from tax returns</u>	All Flow- throughs	Major Flow- throughs (Over \$50M receipts)	All C Corporations	Major C Corporations (Over \$50M receipts)
	(As percentage of all businesses)			
Number of businesses	93%	--	7%	--
Business receipts	36%	14%	64%	54%
Wages and salaries	34%	10%	66%	53%
Net income	50%	16%	50%	48%

Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

Flow-through Income and Individual Income Taxes, 2006

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

* = "Flow-through income/loss" includes net ordinary income from sole proprietorships, S corporations, and partnerships plus net long-term and short-term gains from partnerships, S corporations, estates, and trusts.

Source: U.S. Department of the Treasury, Office of Tax Analysis - analysis of unpublished IRS data.

Example of Increased Marginal Rate on a Small Business Owner

Business Taxable Income	\$500,000
Tax Under Current Law	\$146,700
Tax With Higher Rates	\$166,300
Tax Increase	\$19,600
Percent Increase	13%

Source: Finance Committee Republican Staff calculations. Assumes taxpayer files jointly and has two dependents. Assumes current law tax brackets. Includes marginal rate effects of restoring Personal Exemption Phase-out and Itemized Deduction Cutback.

Small-business owner total household income from all sources for the year, including income from other adult members of the household, likely to be \$250,000 or more.

(As a percentage of all firms by number of employees)

1-9 Employees	10-19 Employees	20-249 Employees	All Firms
6.40%	20.6%	40.0%	10.2%

March 14, 2003

The Honorable Charles Grassley
United States Senate
Washington, DC 20510

Dear Chairman Grassley:

On behalf of the National Federation of Independent Business (NFIB), the Small Business Legislative Council (SBLC) and the Small Business Survival Committee (SBSC), I am writing to express our strong support for the accelerated rate reduction and expensing provisions included in the economic growth package proposed by President Bush. Many small businesses are struggling as a result of the sluggish economy. These tax relief measures will encourage small business investment and job creation providing the jump-start our economy so urgently needs.

◆ **Accelerating Income Tax Relief:** Approximately 85 percent of small businesses file their tax returns as individuals. An increase in tax refunds means small firms will have more resources and more capital to put back into growing their businesses. A series of studies by four top tax economists examined the effect of tax rate cuts on sole proprietors. Their results indicate that a 5 percent point cut in rates would increase capital investment by about 10 percent. And, they found that dropping the top tax rate from 39.6 percent to 33.2 percent would increase hiring by 12.1 percent.¹

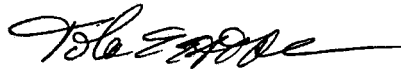
◆ **Raising Expensing Limits:** The President's plan would increase the \$25,000 expensing limit to \$75,000, and index it for inflation. The plan also increases the annual total investment limit from \$200,000 to \$325,000. Allowing small business owners to immediately expense critical investments is a key component to the expansion of our economy. This important incentive will generate substantial economic activity by encouraging small businesses to upgrade and modernize equipment. It will help to create jobs and further enhance the productivity and competitiveness of our small business sector.

Thank you for your support of small business. We appreciate your work to restore fiscal discipline to federal spending, and we hope that you will support these provisions to help grow our economy.

Sincerely,



Dan Danner
Senior Vice President
Public Policy
The National Federation
of Independent Business (NFIB)



John Satajai
President and General Counsel
The Small Business Legislative
Council (SBLC)



Karen Kerrigan
Chairwoman
The Small Business Survival
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¹ Economic Policy and the Start-up, Survival, and Growth of Entrepreneurial Ventures, by Douglas Holtz-Eakin, Syracuse University and Harvey S. Rosen, Princeton University.