# DEMOCRATS' TICKING TAX BOMB, PART V

## How Small Businesses Will Be Affected
## If the 2001 and 2003 Tax Reductions Are Not Extended

As described in Part I of this series, when the clock strikes midnight on December 31, 2012, the low-tax policies originally enacted in 2001 and 2003 – and extended, at Republicans' urging, by a Democrat Congress and President Obama in 2010 – are again scheduled to expire. This will result in higher taxes for every American who pays income taxes, as well as for small businesses, the engines of job creation. House Republicans have announced plans to hold a vote prior to the August recess on legislation to extend all of these low-tax policies again, while also establishing a pathway to comprehensive tax reform next year. President Obama and the Democrats who control Washington, meanwhile, have made it clear that they are prepared to allow all of these tax hikes – totaling more than $4 trillion over the next decade – to take effect at the end of this year. Part II of this series provided some examples showing how much more in taxes typical taxpayers can expect to pay as a result of this looming tax hike, Part III detailed how these tax increases will affect middle-class families, and Part IV described their impact on seniors.

This document explores how these looming tax increases will directly affect small businesses. Among the most significant small business-related tax increases that will take effect on January 1, 2013 are:

- **An across the board increase in the individual income tax rates,** which apply to 95 percent of all U.S. businesses and 46 percent of all business income.
- **A sharp reduction in expensing limits**, forcing small businesses to pay much higher taxes on investments in depreciable property and equipment.
- **A significant increase in the death tax** to a top rate of 55 percent, with an exemption of only $1 million, subjecting nearly 14 times as many small businesses and 24 times as many farms to the death tax.

## Tax Rates Increased

Preventing individual income tax rates from rising is critical to the small businesses that have created approximately two-thirds of new U.S. jobs over recent years. According to the Joint Committee on Taxation (JCT), 95 percent of all U.S. non-farm businesses in 2009 were S corporations, partnerships, or sole proprietorships – "pass-through" or "flow-through" business entities commonly used by small businesses that file their taxes on their owners' individual Form 1040s and pay taxes at the individual income tax rates. Indeed, according to the National Federation of Independent Business (NFIB), "[m]ost small businesses do not pay the corporate tax. If the tax rates enacted in 2001 and 2003 are allowed to expire, the small business sector would see its taxes increase significantly."  Similarly, the National Association of Manufacturers reports that "[a]lmost 70 percent of manufacturers operate as 'S'-corporations or other 'flow-throughs,' and thereby pay income taxes at individual rates.  For 'flow-through' entities, it is critical that the tax rates on individuals be as low as possible.  Tax increases will take resources away from investment and jobs, and uncertainty in the tax code creates significant planning hurdles for manufacturers."

These small businesses that pay at the individual income tax rates earn approximately half of the total income earned by all businesses in America.  According to JCT, 46 percent of total business income earned by all U.S. non-farm businesses in 2009 was earned by such pass-through businesses.  **<u>If Democrats allow the year-end tax increases to go into effect, 100 percent of this small business income will be subject to higher taxes.</u>**  With the limited availability of credit for small businesses and fewer customers buying their products due to the ongoing economic downturn, tax rate increases will make it even more difficult for small businesses to create jobs, retain workers, and pay good wages.  As one small manufacturer put it in recent testimony before the Ways and Means Committee: "Tax increases simply leave less for investment and jobs.  The last thing Congress should do right now is raise taxes on small manufacturers just as we are rebounding after a devastating recession, especially to finance more government spending."

Some Democrats claim they intend to limit their tax increase on small businesses to "just" those earning more than $200,000 (singles) and $250,000 (joint returns), asserting that this somewhat smaller tax hike would apply to "only" 2 to 3 percent of small businesses.  This is a highly misleading statistic.  According to JCT, this supposedly more "modest" tax increase on those in the top two rates would still mean higher taxes on:

- **940,000 small businesses** nationwide – an average of 2,160 small businesses per Congressional district; and

- **53 percent of all small business <u>income</u>**.  Looking at the percentage of income affected by this version of the Democrats' small business tax hike, rather than merely at the percentage of small businesses affected, is a far more meaningful way to assess its impact on jobs.  In suggesting that only 2 or 3 percent of small businesses would be affected, Democrats are effectively giving equal weight to a Main Street retailer or small manufacturer that generates a significant amount of business income and an individual who happens to derive a very small amount of business income from part-time sales work that he or she may do from home.  While both are entirely noble business activities that should be honored by policymakers, it is clear that the Main Street retailer and small manufacturer are the types of small businesses that are more likely to create the substantial number of jobs that millions of Americans so desperately need.  For this reason, a far better measure of the impact of higher taxes on small businesses' ability to retain workers or create new jobs is the percentage of small business **<u>income</u>** that would be affected – 53 percent under this modified version of the Democrats' plan.

This so-called more "modest" tax increase being supported by Democrats hits the very businesses that are responsible for a meaningful amount of job creation in America. As NFIB has previously noted, "the businesses most likely to face a tax increase by raising the top two rates are businesses employing between 20 and 250 employees. According to U.S. Census data, businesses with between 20 and 299 workers employ more than 25 percent of the total workforce." Given the number of small businesses affected and the percentage of small business income that would be subject to higher taxes, it is not surprising that Ernst and Young has found that this supposedly more "modest" tax increase would still destroy 710,000 jobs.

| TAX RATES ON SMALL BUSINESSES | | |
|---|---|---|
| **Portion of Small Business Income Taxed at Certain Marginal Rates** | **Rates Without Democrats' 2013 Tax Hikes** | **Rates With Democrats' 2013 Tax Hikes** |
| 47 percent of small business income | 10 percent | 15 percent* |
| | 15 percent | 15 percent |
| | 25 percent | 28 percent |
| | 28 percent | 31 percent |
| 53 percent of small business income | 33 percent | 36 percent |
| | 35 percent | 39.6 percent (40.8 percent when also accounting for the additional hidden rate of approximately 1.2 percent from the reinstatement of the Pease limitation) |

** Note that 100 percent of owners of sole proprietorships, partnerships, and S corporations that have taxable income will face a tax increase as a result of the expiration of the 10 percent bracket.*

## Small Business Expensing Dramatically Reduced

Section 179 of the tax code allows small businesses to expense (i.e., deduct immediately, instead of recovering over time) the full cost of a certain amount of property and equipment that they place into service each year. This deduction makes it simpler and cheaper for small businesses to expand and modernize by purchasing more capital equipment. Setting aside additional, temporary adjustments provided over the past several years in response to the economic downturn, small businesses can generally expense up to $125,000 annually (indexed for inflation each year), with the phase-out range beginning when certain capital expenditures exceed $500,000 (also indexed for inflation). As shown in the table below, the Democrats' 2013 tax increase will significantly reduce these limits, leaving small businesses with much higher after-tax costs for their capital investments.

| SMALL BUSINESS EXPENSING LIMITS IN 2013 | | |
|---|---|---|
| **Small Business Expensing Provision** | **Without Democrats' 2013 Tax Hikes** | **With Democrats' 2013 Tax Hikes** |
| Maximum capital investment that can be fully expensed | $142,000 (indexed for inflation) | $25,000 |
| Phase-out begins when capital spending exceeds | $570,000 (indexed for inflation) | $200,000 |

## Death Taxes Significantly Increased

For 2011 and 2012, the estate tax has featured an exemption amount of $5 million and $5.12 million, respectively (the exemption is indexed for inflation), with the assets of taxable estates subject to a top rate of 35 percent. In addition, the exemption is "portable" – i.e., a surviving spouse can use any of the decedent's remaining exemption amount, effectively doubling the exemption available to a married couple. Unless the Democrats who control Washington act, however, the estate tax will revert to its pre-2001 parameters, dramatically expanding its reach. Specifically, the exemption amount will drop to $1 million (not indexed for inflation), the top rate will skyrocket to a confiscatory 55 percent, and there will be no portability. In many cases, the estate tax represents double or even triple taxation: the taxpayer paid tax when the income was earned, paid tax again on dividends or interest when that after-tax income was later invested, and then the estate must pay tax on the assets purchased with that previously-taxed income before those assets can be passed on to the taxpayer's heirs.

Because they are often asset-rich but cash-poor, small businesses and family farms will be hit particularly hard by the significant expansion of the estate tax under the Democrats' 2013 tax hike. With the much higher rate, much lower exemption amount, and no portability, it is far more likely a small business will have to be sold or liquidated just to pay the estate tax. Regrettably, jobs are lost when small businesses and family farms are sold off to pay estate taxes or when those businesses make decisions not to expand because of anticipated estate tax liabilities. According to JCT, the Democrats' tax hike will cause 15 times as many taxable estates to pay estate taxes in 2013 compared to 2012 – including nearly 14 times as many small business estates and 24 times as many farm estates. As NFIB has noted, the Democrats' position "represents a significant step backwards from the 2010 compromise reached on the estate tax," and "[t]he uncertainty of the current law has left many family-owned businesses guessing about their estate tax liabilities and unable to make prudent business decisions."

| HIGHER DEATH TAXES ON SMALL BUSINESSES AND FAMILY FARMS | | |
|---|---|---|
| **Estate Tax Provision** | **2013**<br>**<u>Without</u> Democrats' Tax Hike** | **2013**<br>**<u>With</u> Democrats' Tax Hike** |
| Exemption amount | $5.23 million*<br>(indexed for inflation) | $1 million<br>(not indexed for inflation) |
| Top rate | 35 percent | 55 percent |
| Portability rules? | Yes | No |

** JCT estimate reflecting the expected inflation adjustment for 2013.*

While the effect of Democrats' 2013 tax increases on any particular small business will depend on that business's specific circumstances, it is clear that this is a massive tax hike that struggling small businesses and their hard-working employees simply cannot afford. For more detail about the effect of the Democrats' ticking tax bomb on investors, stay tuned for Part VI of this series, coming soon.