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Raising the Top Two Marginal Tax Rates: How Many Small Businesses Impacted?

The on-going debate over increases in the top two marginal income tax rates often centers on the proportion of small-business owners impacted by the proposed tax increase.[1] Proponents of the increase commonly argue that 3 percent of small-business owners would be impacted.[2] A better estimate, supported by Treasury data, is 14 percent, about five times the number proponents of the tax increase concede.

The issue - How many small businesses face a tax increase?

The proposal to raise the top two income tax brackets actually contains more than the rate increases on ordinary income. It also includes a hike in the tax on dividends that can effectively almost triple the top marginal rate and more than double it on capital gains. The proposal further phases-out deductions for high income rate payers, which serves to increase the alternative minimum tax (AMT). But perhaps as notable, this latter step effectively raises the adjusted gross income (AGI) of some tax-payers thereby pushing their taxable income into the top two brackets. That raises the question: How many owners of small businesses face the resulting tax increase?

Treasury's data

Proponents argue that 3 percent of small businesses would be impacted by that tax increase. They apparently draw that number from the Treasury's recent technical paper, "Methodology to Identify Small Businesses and Their Owners."[3] That technical paper is also the document that provides the primary data to support our 14 percent estimate.

Defining "small business"

The key to understanding the difference between 3 percent and 14 percent is the definition of a business. The context is critical. The Treasury effectively defines a business for its analytic purposes as one with at least $10,000 in receipts for the tax year 2007 and engages in business-like activity. The result is approximately 20 million small businesses. The definition, therefore, includes people who have part-time operations, hobby businesses, income supplements, etc. *Treasury calculates that about one in five of these enterprises employ people.*

[1] The proposed increase raises the top two marginal statutory income tax rates from 33% and 35% to 36% and 39.6%. However, additional increases such as the Patient Protection and Affordable Care (PPACA) Medicare surtax, raise the top rate to 40.9%.
[2] For example, see Steny Hoyer's comments in The Hill, Mike Lillis, "Hoyer: GOP 'dead, flat wrong' on tax hike for small business," July, 10, 2012. http://thehill.com/homenews/house/236999-hoyer-gop-dead-flat-wrong-on-small-business-tax-hike.
[3] Knittel, M., S. Nelson, J. DeBacker, J. Kitchen, J. Pearce, and R. Prisinzano (2011). "Methodology to Identify Small Businesses and Their Owners," Office of Tax Analysis, Department of the Treasury, Technical Paper 4, August.

Part-time businesses are *not* a bad thing. But they typically provide their owner's minimal income, require minimal investment, and are not likely to ever hire anyone. It is therefore disingenuous to argue that for purposes of examining the impact of tax policy these fledgling businesses should be counted.

Treasury arbitrarily caps the size of a "small business" at $10 million in annual gross receipts, a sales figure quite low when examining accepted employment levels for small firms. A quick crosswalk[4] of gross receipts and employment indicates $10 to $20 million in gross averages 70 to 90 employees.[5] Two hundred employees equates to about $50 million in annual gross receipts. Thus, the Treasury data breaks at $10 million in gross should be increased when calculating the impact of this proposal on small business.

The 14 percent estimate

The best estimate for the number of small-business owners impacted by the proposed hike in the top two federal income tax brackets is 14 percent, almost five times the estimate suggested by proponents of increasing the top rates. The 14 percent estimate was developed principally from data presented in Treasury's technical paper cited above.

Treasury's 10 percent and 24 percent estimates

Treasury offers two figures for the percentage of small, employer pass-through business owners (small-business owners) that pay one of the top two rates: 10 percent and 24 percent. The 10 percent figure is the number of small, employer pass-through business owners that fell in either the 33% or the 35% tax bracket in the 2007 tax year. Treasury's 24 percent figure is the number of small, employing business owners whose AGI in 2007 was $200,000 or more, the level at which the 33 percent bracket kicks in for single filers. Neither figure is perfect, but both present a sound basis for adjustment in order to achieve an estimate of the phenomenon.

Single and joint filers

The discrepancy between 10 percent and 24 percent is notable. Why the difference? One likely reason, though Treasury presents no data on the issue, is the proportion of single and joint filers. The 33% rate for single filers begins at $200,000; the 33% rate for joint filers begins at $250,000. Survey data tells us that small-business owners are very likely to be married (85 percent).[6] Presumably, the owner and his/her spouse file jointly. That means the 33% threshold for most in the two top brackets is $250,000. The implication is that the 24 percent figure is too high as a measure of those in at least one of the top two brackets; the number should be ratcheted down. How far down is another question.

Treasury shows that 21 percent have an ACGI of $100,000 - $200,000; 16 percent have one from $200,000 - $500,000; and 5 percent from $500,000 - $1 million. Though there are insufficient data points to provide a slope within the $200,000 - $500,000 category, the available distribution of data points indicates a proportionally large percentage fall between $200,000 and $250,000. The result is that absolute percentage should fall several percentage points. Still, Treasury reports that 8 percent have an AGI of $500,000 or more. Those data suggest that the decline from the 24 percent level would likely fall somewhere into the mid-teens.

[4] A crosswalk is simply a cross-tabulation, which in this case allows someone to translate business size in employees to business size in annual gross receipts and vice versa. Since employees are not full-time equivalents (FTEs) in the cross-walk, employee size of business is somewhat large compared to annual gross receipts.

[5] U.S. Small Business Administration, Office of Advocacy, http://www.sba.gov/advocacy/849/12162 static_US.xlsx.

[6] "Families in Business," (2002). *National Small Business Poll*. (ed.) W.J. Dennis, Jr., Vol. 2, Iss. 6, NFIB Research Foundation, Washington.

Add back C-corporation owners

Much of the detail in Treasury's analysis includes only pass-through entities, for all practical purposes, S-corporations, LLCs, partnerships and sole-proprietorships. It excludes C-corporations (unless the owner also owns a pass-through) because the tie between owner and firm is too difficult to establish with the data available. However, Treasury reports 864,000 employing C-corporations or 17 percent of all employers. C-corporations are larger on average than pass-throughs. For example, 14.3 percent of employing C-corporations have between 20 and 500 employees; pass-throughs have 9.1 percent in that size category.[7] Owners of larger, small firms more often have incomes over $200,000 than owners of smaller, small firms.[8] Those with more than 10 employees are more than twice as likely to have incomes $200,000 and over as those with fewer than 10 employees. A greater percentage of C-corporation owners than pass-through owners, therefore, face the higher rates. A crude calculation adds a percentage point to the 10 percent now experiencing rates of 33% or higher, though another point is likely warranted.

Raise the small business ceiling to $25 million

The Treasury study arbitrarily caps the size of a small pass-through at $10 million in annual revenues. The cross-walk of annual gross receipts and employees noted earlier places the cap at the equivalent of about 50 employees. Raising the cap to $25 million still places it significantly below the equivalent of our general understanding of "small business," including employee-size definitions employed by the U.S. Small Business Administration and the European Union.[9] Treasury's analysis finds 12 percent of all employers fall in one of the top two brackets. A $25 million cap would, therefore, add about a percent to the total.

The AMT

Changes in the Alternative Minimum Tax (AMT) do not change a taxpayer's AGI, but they usually do change the taxpayer's effective marginal tax rate. The marginal rate changes typically are not large and vary by the type of tax preference changes,[10] but they can push a taxpayer not already there into one of the two top brackets. Recall, the proposed increase in the top two brackets is accompanied by changes in the AMT.

The AMT is effectively an extra tax levied for taking too many legal deductions. Therefore, a small-business owner taxpayer short of the 33% threshold, but paying the AMT, could effectively already be paying a marginal tax rate at or above the 33% level. Treasury tells us that 18 percent pay the top AMT rate (28%) (in addition to the 10 percent already known to pay the top rates). The greatest percentage of AMT taxpayers (all taxpayers, not just small-business owner taxpayers) fall within the $200,000 - $500,000 income category and the second greatest number in the $100,000 - $200,000 category.[11] While the AMT change will not directly affect the number actually in the top two brackets, it suggests that an unknown number are already paying marginal rates that approximate the top rates. The proposed AMT changes will simply increase those marginal rates.

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[7] U.S. Small Business Administration, op. cit.

[8] "Finance Questions" (2007). *National Small Business Poll*. (ed.) W.J. Dennis, Jr., Vol. 7, Iss. 7, NFIB Research Foundation, Washington.

[9] The former is typically 500 employees or fewer and the latter is 250 or fewer.

[10] See, D.R. Feenberg and J.M. Poterba (2003). "The Alternative Minimum Tax and Effective Marginal Tax Rates," Working Paper 03-37, Working Paper Series, Department of Economics, Massachusetts Institute of Technology, October.

[11] L.E. Burman, W.G. Gale, G. Leiserson, and J. Rohaly (2007). "The AMT: What's Wrong and How to Fix It," *National Tax Journal*. Vol. LX, No. 3, September. See, Table 3.

A reality check

Survey data can also provide complementary, and more current, data to make income estimates.[12] The NFIB Research Foundation attempted to elicit total income from a national (not NFIB) random sample (n=553) of small employers in 2007.[13] The survey, conducted for the Foundation by The Gallup Organization, focused on pre-tax total family income (take home) rather than AGI, included owners of C-corporations rather than excluding them, and clearly defined a recognizable population, but its results are similar to the data produced by Treasury. It showed that 13 - 14 percent of small business owners had income of $200,000 or more in that year. However, 14 percent refused to provide the data. Examining that group across varying demographics suggests no systematic pattern, allowing its proportional distribution over existing classifications. This procedure added about two points for a total of 15 - 16 percent with incomes over $200,000.

Conclusion

Proponents of the proposal to raise the top two income tax brackets claim that it will affect only 3 percent of small businesses. Principally using data from a Treasury analysis of small-business taxable income, we calculate the proportion affected is closer to 14 percent. The actual number may be 13 percent or 15 percent. The available data do not permit a precise figure, only an estimate. But 14 percent is almost five times the number proponents offer.

This analysis argues neither for nor against a tax increase on the top two rates. It does argue that the number put forward by proponents in support of their tax rate hike proposal, grossly underestimates its impact on small business.

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[12] B.W. Johnson and Kevin Moore (2008). "Differences in Income Estimates Derived from Survey and Tax Data," www.irs.gov/pub/irs-soi/08rpjohnson.pdf.

[13] "Finance Questions" (2007). op. cit.