MINNESOTA BUDGET PROJECT

An initiative of the Minnesota Council of Nonprofits

'Fourth Tier' Would Have Little Impact on Small Businesses

A new state income tax bracket proposed for the highest-income Minnesotans would not touch most small businesses, since only a small share of households that report "small business" income would be in the new bracket.

The proposed new income tax bracket provides the opportunity to raise adequate revenues for investments in education and the high-quality workforce Minnesota needs to be competitive. It would also help resolve the chronic gap between what the state needs to fund basic services and the amount of revenue it is able to raise.

Governor Dayton has proposed a new individual income tax bracket – a "fourth tier" – that would apply a 9.85 percent tax rate on taxable income above $250,000 for married couples, $200,000 for head-of-household filers and $150,000 for single filers.

While some have raised concerns about the potential impact on small businesses, only 6.0 percent of households with what is broadly called "small business" income have income in the new bracket,[1] and many of these aren't traditional small businesses.

Businesses Taxed on the Personal Income Tax Aren't Necessarily Small

What determines whether a business pays taxes on its profits through the corporate franchise tax or the individual income tax is how that business is legally structured, not its size. However, in tax debates, people may use "small business" as shorthand for businesses whose owners choose to have their profits taxed through the individual income tax. Some such businesses are actually quite large. These are in contrast to businesses structured as corporations (C-Corps) that pay taxes on their profits through the corporate franchise tax.

Businesses that pay taxes on their profits through the individual income tax include partnerships, sole proprietorships and subchapter-S Corporations (S-Corps).[2] Profits from these businesses "pass through" or "flow through" to their owners and/or shareholders, who report the profits on their federal and state income tax returns.

Households with flow-through income go well beyond those who run a small family business, such as a restaurant, hardware store or barbershop. They also include doctors, lawyers and other professionals who have structured their businesses as S-Corps or partnerships. Passive investors in small businesses also fall into this category, and flow-through income is often not their primary source of income. Only 28 percent of households with incomes high enough to be in the proposed fourth tier receive more than 20 percent of their total income from flow-through sources. Less than half (46 percent) of households with incomes in the proposed fourth tier have any flow-through income.[3]

Minnesota policymakers can adopt a fourth tier without fear of a substantial impact on small businesses.

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[1] Minnesota Department of Revenue. Data refer to returns with positive income from sole proprietors, S-Corporations, or partnerships.
[2] An LLC can choose to be taxed as a C-corporation, an S-corporation or as a sole proprietor.
[3] Minnesota Department of Revenue.