Few Small Business Owners Would Be Impacted by the 2010 Legislature's Income Tax Increase on High-Income Households

No business or individual alone can provide for an educated workforce or safe roads and bridges. Taxes pay for these essential services. The 2010 Legislature sought to maintain essential services through a mix of spending cuts and revenue increases, including an income tax increase on the highest-income households. The Legislature proposed creating a new fourth income tax bracket on taxable income above $200,000 for married couples, which would have added $595 million to FY 2012-13 revenues. It was vetoed by Governor Pawlenty.

During the debate, concerns were raised about the potential impact that the proposal would have on small businesses. But in fact, an analysis found that the new fourth income tax bracket would affect **only 6.4 percent of households with small business income**.[1] While only a small number of households with small business income would fall into the fourth income tax bracket, 46 percent of households in that bracket have at least $1 of business income.[2]

Small Businesses are Taxed at the Owner or Shareholder Level

There is no universal definition of "small business," but for tax purposes, it means that the business is taxed at the owner or shareholder level through the individual income tax. In contrast, corporations (C-Corps) are taxed at the corporate level and are subject to the corporate franchise tax.

A small business can have one of several ownership structures, such as a partnership, sole proprietorship, subchapter S Corporation (S-Corp) or a Limited Liability Company (LLC).[3] Each year, the business fills out a statement of profit and loss that shows the business' net profit, if any. The profit is then reported to the owners and/or shareholders. The owners, in turn, report this "passthrough" income on their federal and state income tax returns. (S-Corporations and LLCs also pay an entity level fee that ranges between $100 and $5,000.)[4]

For example: John Q. Public owns a lawn service business, which is organized as a sole proprietorship. He earns gross income of $200,000. When he files his individual income tax return, he can deduct many business expenses from this gross income, including car expenses, licenses and fees, contract labor, health insurance, depreciation on purchased equipment, office expenses, rent, repairs, travel, business meals and entertainment, and pension plan contributions. If he has employees, he can also deduct their wages and employee benefit costs. After these deductions, he reports a net profit of $50,000 as income, and pays individual income tax on that $50,000 – just as a salaried worker would.

Taxes are Just One of Many Factors that Drive Business Activity

If the state's overriding goal is small business creation, state tax policy is a weak lever. A U.S. Small Business Administration-commissioned study found that, "State tax policy, including both tax rates and the type of taxes in a state's portfolio, has only a modest effect on aggregate state entrepreneurship rates."[5]

An educated workforce and transportation systems also affect a state's ability to attract and maintain businesses. Many factors determine small business activity, such as the personal situation of the small business owner, the health of the economy, and regulations. In fact, health care costs regularly place higher than taxes as a barrier to business growth in surveys of businesses. As state leaders work to solve Minnesota's budget deficit and promote a healthy economy, they should remember that taxes are just one component of the business climate.

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[1] Minnesota Department of Revenue analysis of House File 2037. The proposal would impact taxable income above $100,000 for married filing separate filers, $113,110 for single filers and $170,350 for head-of-household filers. "Small business income" is flow-through business income from a sole proprietor, farm, partnership, or S-corporations.

[2] Only 25 percent of the households impacted by the proposal receive at least one-fifth of their total income from flow-through income.

[3] An LLC can choose to be taxed as a C-Corporation, an S-corporation or as a sole proprietor.

[4] Center on Budget and Policy Priorities, *Reforming the Tax Treatment of S-Corporations and Limited Liability Companies Can Help States Finance Public Services*, April 2009.

[5] Donald Bruce and John Deskins, *State Tax Policy and Entrepreneurial Activity*, November 2006.