



MEMORANDUM

TO: Reporters and Editors
RE: House surtax
DA: Wednesday, July 15, 2009-07-15

Republican tax counsels for the Senate Committee on Finance today released the following Q&A regarding the effect of the tax increases on small businesses proposed by Democratic leaders in the House of Representatives to pay for President Obama's health care reform legislation. Charts accompanying the text of the Q&A are posted in the Grassley news releases, along with this document, at <http://finance.senate.gov>.

Questions and answers on the effect of the tax increases on small businesses proposed by President Obama and House Democrats

Question #1: What is a small business?

Answer #1: SBA says a 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. President Obama agrees that small businesses create at least 70% of new jobs. Treasury says small business accounts for 95% of businesses, 46% of

business receipts, 47% of wages paid, and 52% of net business income. (This is both flow-through entities and small C corporations).

Question #3: How are small businesses taxed?

Answer #3: Small business owners pay 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 President Obama's and the House Democrats' plans?

Answer #4: Currently, the top two rates are 33% and 35%. President Obama wants to raise those rates to 41% and 41% respectively for a family of four (when the PEP and "PEASE" hidden rates are reinstated) in 2011. To partially offset health care reform, House Democrats have proposed an additional graduated surtax of 2%, 3% or 5.4% on those earning \$280,000 or more (\$175,000 or more if you're married filing separately), which is referred to as the small business surtax. (Note: the 2% and 3% surtax will start in 2011 at 1% and 1.5%, respectively, but will go up to 2% and 3%, respectively, unless OMB determines in 2012 that health care savings of greater than \$675 billion will be achieved by the end of 2019). This small business surtax would raise the marginal tax rate for a family of four in either of the top two brackets to a range from 43% to 46.4%. This small business surtax would take effect in 2011.

For those small businesses in the top two brackets, President Obama's proposals and the House Democrats' small business surtax would raise the marginal rates by a minimum of 23% and a maximum of 33%. The 33% increase in the marginal rate comes from raising the top capital gains and dividends rate from 15% to 20% on distributions from small C corporations (5% divided by 15%). The 33% increase in the marginal rate also comes from raising the current 35% rate to 46.4% (11.4% divided by 35%).

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 the effect as minimal. The House Democratic Leadership press release dated July 14, 2009 states that the Joint Committee on Taxation says that only 4% of small businesses will face a tax increase under their surtax. 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 Joint Committee on Taxation statistic?

Answer #6: Yes, opponents agree with the Joint Committee on Taxation's conclusions.

Question #7: If the Joint Committee on Taxation is correct, do you agree with the proponents that the small business impact is minimal?

Answer #7: No. Data from the Joint Committee on Taxation shows that at least 55% of the revenue raised by increasing the top two rates in 2011 comes from small business income. 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, including the small business surtax, 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. President Obama and House Democrats are willing to risk this shift of capital out of small business in exchange for more

progressivity. Senate and House Republicans do 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 a 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 \$145,363 in Federal income tax. That's where Senate and House Republicans want to keep the level of taxation on this small business. President Obama and House Democrats would raise the small business owner's taxes by \$23,750. Absent new unexpected income, the small

business owner would have to cut costs by \$23,750 out of payroll, 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. The marginal income tax rate for this business owner has gone from 35% to 43%, which amounts to a 23% increase of the marginal tax rate. (Note: this calculation includes PEP and Pease effects).

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 4% of small businesses according to the Joint Committee on Taxation. The impact can't be very much, right?

Answer#10: Wrong. The affected business activity and workers are not proportionate to the percentage of small businesses affected. 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 President Obama's advisors have said singles above \$200,000 are targeted for tax

increases, it is fair to look at survey data for these small business owners 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 President Obama and House Democrats for a marginal rate increase of between 23% 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 President 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. (See the NFIB, SBLC, and SSC 3-14-03 letter, attached below).

Question #11: Given the additional tax burden on small businesses attributable to the surtax, are there other negative economic issues to consider?

Answer#11: Dr. Lawrence Lindsey, the Director of the National Economic Council during 2001-2002, stated in a July 14, 2009 Congress Daily article, "When marginal tax rates go over 40 percent, the evidence suggests that

the excess burden of collecting additional revenue rises very sharply, making the cost to the private sector of moving additional funds from the private sector several times the additional revenue raised." Moreover, the nonpartisan Joint Committee on Taxation notes in connection with revenue estimates regarding marginal rate increases, "We anticipate that taxpayers would respond to the increased marginal rate by utilizing tax-planning and tax-avoidance strategies that will decrease the amount of income subject to taxation."