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REDUCING THE TOP TAX RATES: HOW MUCH BENEFIT TO SMALL BUSINESS?

Many More Small Business Owners Would Fail to Benefit From Bush Tax Plan than Would Benefit from Cut in Top Tax Rates

In recent months, the President and senior Bush Administration officials have repeatedly stressed the importance to small business of reducing the top income tax rate. The President highlighted this theme in an address to small business owners on March 16, in which he declared that more than 17 million small business owners would benefit from reducing the top rate.¹ A Treasury Department press release issued the same day stated there were 17.4 million small business owners and sole proprietorships whose business profits are taxed through the individual rather than the corporate income tax and that “many” of these 17.4 million owners pay the top rate and would benefit from a reduction in it.²

This brief analysis of small business tax data from the Internal Revenue Service, the Treasury Department, and Citizens for Tax Justice finds, however, that relatively few small business owners pay the top rate and that cutting that rate would be a highly inefficient way of helping small businesses, it would bypass most small business owners entirely. In fact, small business owners would be far more likely to receive no tax reduction whatsoever from the Administration’s tax package than to benefit from a reduction in the top rate. Moreover, small business owners would be much more likely to benefit from an increase in the Earned Income Tax Credit — a tax credit for low- and moderate-income workers and self-employed individuals — than from a reduction in the top rate. The President’s plan includes no improvement in the EITC.

- For every small business owner who would benefit from reducing the top income tax rate of 39.6 percent, there would be 15 small business owners who would not benefit from the Administration’s tax package.³

¹ The President said: “According to the Treasury Department, nationwide there are more than 17.4 million small business owners and entrepreneurs who stand to benefit from dropping the top rate from 39.6 percent to 33 percent.” See “Remarks by the President During Meeting with Small Business Owners,” The White House, March 16, 2001.

² The Treasury release said: “...at least 17.4 million small business owners and entrepreneurs, many of whom currently pay at the 39.6% rate, stand to benefit from the President’s tax relief plan.” See “Treasury Releases Latest Number of Income Tax Returns Filed by Small Business Owners and Entrepreneurs,” U.S. Department of Treasury, March 16, 2001.

³ The comparisons in this and the next bullet overstate the degree to which small business owners benefit from the Bush tax package. The comparisons assume that all small business owners in the 39.6 percent bracket would benefit from the Bush proposal to lower the top rate. Because of the Alternative Minimum Tax, however, a significant portion of these small business owners would not benefit from the reduction in the marginal tax rate from 39.6 percent to 33 percent.

- For every small business owner who would benefit from reducing the top rate, there are 12 small business owners who receive the Earned Income Tax Credit and could benefit from an improvement in it.

As Table 1 below indicates, only 1.4 percent of small business owners with positive business income are subject to the top rate of 39.6 percent. Another 2.3 percent are in the 36 percent bracket. By contrast, 21 percent do not earn enough to owe federal income tax. (They pay payroll and other taxes.)

Moreover, a total of 69 percent of small business owners either are in the 15 percent tax bracket or are not subject to income tax because their earnings are too low. A substantial number of these owners qualify for the Earned Income Tax Credit; about one of every six small business owners with positive business income qualifies for the EITC.

Few Small Business Owners Pay the Top Rate

Despite its claims that lowering the top income tax rate is of great importance to small business owners, the Bush Administration has never released information on how many small business owners would benefit from different aspects of its tax package, including how many would benefit from reducing the top income tax rates. IRS publications, however, contain relevant information. The IRS data indicate:

- In 1998, only 3.4 percent of tax filers with positive small business income had

Table 1. Income Tax Returns with Positive Income, 2001

Top Marginal Tax Rate	Number of Returns (in thousands)	Percentage of Small Business Returns
Zero	2,761	20.8%
15 percent	6,462	48.6%
28 percent	2,963	22.3%
31 percent	612	4.6%
36 percent	311	2.3%
39.6 percent	180	1.4%
All	13,289	100%
15 percent or less	9,223	69.4%

Source: Citizens for Tax Justice. This table excludes about four million income tax filers which have income losses from a small business.

adjusted gross incomes above \$200,000. (The vast majority of taxpayers subject to the 36 percent or 39.6 percent tax rates have incomes above \$200,000.)

- By contrast, 67 percent of tax filers with positive small business income had adjusted gross incomes of less than \$50,000.

Citizens for Tax Justice, using the tax model of the Institute for Taxation and Economic Policy, has estimated the number of small business tax filers who will be subject to different income tax rates in 2001. CTJ estimates that in 2001, there will be 13.3 million tax filers that will have positive small business income and another four million who will have income losses from small businesses. Of the 13.3 million tax filers with positive small business income:

- Only 180,000 — or 1.4 percent — will pay the top rate of 39.6 percent.
- Another 311,000 — 2.3 percent of such small business tax filers — are in the 36 percent bracket.

These CTJ estimates are consistent with estimates the Treasury Department's own Office of Tax Analysis has provided. In an analysis dated February 12, 2001, the Office of Tax Analysis estimated that a total of only 600,000 returns with positive business income would be in the 36 percent or 39.6 percent brackets in 2006 and benefit from the proposed reductions in these rates.⁴

The analyses that CTJ and the Office of Tax Analysis have conducted have other implications, as well. They indicate that the President's statement — that 17.4 million small business owners would benefit from dropping the top rate to 33 percent — exaggerated the correct number by a factor of nearly 30. More significantly (since the President presumably did not know his statement was in error), the presence of the Office of Tax Analysis estimate dated February 12 means that when the Treasury issued its press release on March 16 claiming that "many" of the 17.4 million small business owners paid the top rate, it knew — as a result of the OTA analysis completed a month earlier — that only a tiny fraction of these 17.4 million owners actually did so.

Many More Small Business Owners Face Lower Tax Rates

The CTJ data also show that the number of small business owners who do not owe federal income taxes or pay at the 15 percent rate dwarfs the number of small business owners facing the highest tax rates.

⁴ The February 12 OTA analysis uses a broader category of tax filers with business income than the category of small business owners/sole proprietors that Treasury used in its March 16 press release and that the President referred to in his March 16 speech. In addition to sole proprietors, the OTA analysis includes filers with incomes from partnerships (such as law partnerships), S corporations, or rental activities.

- The number of small business tax filers who would receive nothing from the Administration's tax package because they earn too little to owe federal income tax substantially exceeds the number who would benefit from a reduction in the top tax rate. The number of tax filers with positive small business income who owe no federal income tax — and thus would not benefit from any part of the Bush tax package — is estimated to be 2.8 million in 2001. This is 15 times the number of filers with positive small business income who will pay the 39.6 percent rate. In other words, for every small business owner who would benefit from the proposed reduction in the 39.6 percent rate, there are 15 who would receive no tax reduction under the Administration's plan.⁵
- In addition, an estimated 2.2 million small business tax filers receive the Earned Income Tax Credit. For every small business filer who pays the top rate and would benefit from lowering it, there are 12 small business filers who receive the EITC and would benefit from its being expanded. The number of small businesses that would be positively affected by EITC improvements swamps the number that would benefit from reducing the top rate.
- The gap is even greater between the number of small business filers who pay the 15 percent rate and the number who pay the top rate. In 2001, there will be an estimated 6.5 million tax filers with positive small business income in the 15 percent bracket. This is more than 35 times the number of small business filers who will pay the top rate.
- Overall, nearly seven of every 10 tax small business tax filers — 69 percent — either are in the 15 percent bracket or do not earn enough to owe federal income tax.

(Note: One of the tax bills the House of Representatives has passed to date — H.R. 6 — includes an expansion in the EITC for certain married couples and also modestly increases the degree to which the child tax credit is refundable for working families that do not owe income tax. Even so, there still would be many more small business owners who would receive no tax cut under the House-passed tax bills than would benefit from the reduction in the 39.6 percent tax rate.)

Conclusion

While some small business owners would benefit from a reduction in the top income tax rates, the number of such owners is small. The vast majority of business owners would not

⁵ As noted in footnote three, these comparisons do not include the effect of the AMT and thus *overstate* the degree to which the reduction in the top tax rate benefits small business owners.

benefit from reducing the top rates. Implying that large numbers or proportions of small business owners would benefit from cutting the top rate is disingenuous.

What is true for families in general is true for small business owners as well — most would be unaffected by reductions in the top income tax rates because their incomes place them in the low or middle income ranges. Indeed, improvements in the Earned Income Tax Credit and extension of the child credit to more lower-income working families with children would benefit many more small business owners than would reducing the top tax rates.