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PROPOSED KANSAS TAX BREAK FOR “PASS-THROUGH” PROFITS IS POORLY TARGETED AND WILL NOT CREATE JOBS

By Nicholas Johnson and Michael Mazerov

Kansas is seriously considering a new, unprecedented state income tax break — at a huge cost to the state budget — that would benefit large corporations and passive investors, and reward tax avoidance, while failing to meet its stated objective of job creation. The tax break was first proposed by Governor Brownback earlier this year, and since has been incorporated — in slightly different forms — into bills passed by the state House and Senate.

The new tax break would benefit large corporations and investment vehicles more than the small business job creators the governor and legislative advocates claim they are trying to help. At the same time, the proposals would cost the state, at a minimum, \$245 million or more in annual tax revenue that the state otherwise could be using to strengthen its economy. (The primary difference among the proposals is that under the House bill, the full revenue impact would not occur until 2018, while it would hit all at once under the Brownback and Senate plans.)

Whenever it takes effect, this provision would:

- **Create a new and unwarranted tax break for many large businesses.** Under the pending legislation, Kansas would be the first state in the nation to exempt what tax experts call “pass-through” income from an otherwise broad-based income tax. “Pass-through” income is income that — unlike most corporate income — is untaxed at the corporate level and passed through to the owners of a business entity, who normally then pay personal income taxes on it. Many pass-through businesses are very large, and a substantial share of the profit that would be tax-exempt under the governor’s proposal would be earned by large businesses, not small ones.
- **Fail to target the small business job creators the governor seeks to help,** with negative consequences for the Kansas economy. A substantial share of the profit exempted from taxation under the proposal is earned by the wealthy owners of large investment funds and other business entities that have no employees. Another share is earned by individuals who live outside Kansas and would see that income taxed by their home states when Kansas stops taxing it. Small, fast-growing businesses — those most likely to create jobs — likely would see very little of the benefit.

- **Make the Kansas tax system less level and create a new incentive for tax avoidance** at a time when the state needs more resources for schools, transportation, public safety and other priorities that would create a better foundation for future economic growth.

A New Tax Giveaway for Companies, Including Many That Are Very Large

Contrary to claims that this proposal would target small businesses, it would actually give a major new tax break to many *large* companies organized as partnerships, Subchapter S corporations, and limited liability companies (LLCs). These types of businesses are known, collectively, as “pass-through entities” because their income is exempt from taxation at the business level and instead passed-through for tax purposes to individual owners.¹ Pass-through entities’ profits therefore are normally taxed on personal income tax returns. The pending legislation would eliminate this taxation, along with ending the taxation of profits earned by individual or “sole” proprietorships.

Pass-through entities are relatively easy to establish, and many small businesses organize themselves that way. But a lot of large businesses do, too. Tax experts have cautioned that — in the words of one former Bush Administration economic advisor and Congressional Budget Office acting director who now heads the nonpartisan Tax Policy Center — “lawmakers should take care not to assume that all pass-throughs are small businesses.”²

The data show that:

- Large pass-through entities are fairly common. Nationwide, some 35,000 S corporations and 96,000 partnerships have over \$10 million apiece in assets; among those, 15,000 have over \$100 million in assets. Similarly, 76,000 S corporations and 29,000 partnerships have over \$10 million each in revenues.³ All of those are pass-through entities. Known examples of large pass-throughs include the media giant Tribune Co. and the accounting firm PriceWaterhouseCoopers. (The tax status of a privately held company is not public information unless the company chooses to disclose it.)
- Large entities represent a major share of the economic activity of all pass-throughs. Those with more than \$10 million in receipts — that is, the largest 1.6 percent of all pass-through entities — account for 67 percent of total receipts and 61 percent of net income. Sixty-nine percent of the assets of S corporations and partnerships belong to entities with more than \$50 million in assets.
- Even after combining these large pass-through entities with the mostly smaller enterprises organized as sole proprietorships (whose profits would also be tax-exempt under the pending

¹ Corporations that *are* taxable at the corporate level are called “C corporations.”

² Donald B. Marron, Director, Urban-Brookings Tax Policy Center, testimony before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, March 3, 2011.

³ Joint Committee on Taxation. 2008. *Tax Reform: Selected Federal Issues Relating to Small Business and Choice of Entity*. JCX-48-08. Washington, DC: Joint Committee on Taxation. Statistics cited in the subsequent two paragraphs are taken from this source as well.

legislation), 42 percent of total U.S. pass-through profits are earned by business entities with more than \$10 million in annual receipts.

As the data above show, this claim that this plan is targeted at small businesses is exaggerated and misleading.

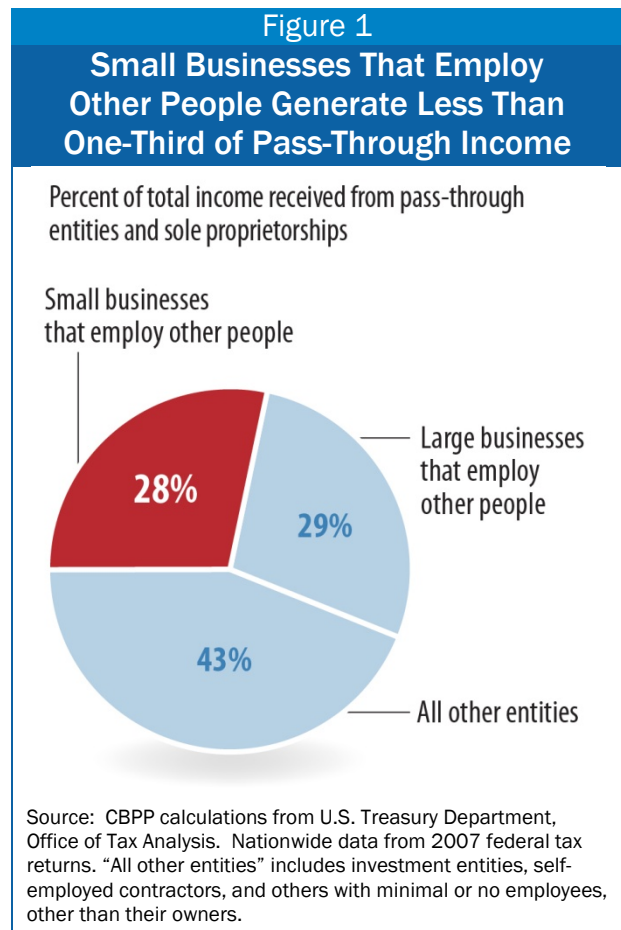
In separate legislation, each house of the Kansas legislature has passed a full tax exemption for pass-through entities. The Senate version would exempt all of the state's nearly 200,000 pass-through entities from income taxation at once, beginning January 1, 2013. The House's bill would phase in this unprecedented tax break over five years. In tax years 2013 to 2015, each taxpayer could exempt up to \$100,000 in non-wage business income. The exemption cap would rise to \$250,000 in 2016 and 2017. By 2018, all pass-through profits in Kansas would go untaxed.

The Proposal Would Fail to Help the Kansas Economy Because It Does Not Target Job-Creating Businesses

To boost the economy, a tax subsidy must target businesses that are likely to create jobs. The pending legislation fails this test in several ways.

For one thing, a large share of pass-through entities and sole proprietorships either aren't businesses in any economically meaningful sense or don't have significant job-creation potential. For example, in many cases a sole proprietorship is used to establish an individual as a self-employed contractor to a single firm, little different from an employee and with no intention to hire anyone else. Many pass-throughs are used purely as investment vehicles, again, with no employees. A study by the nonpartisan research staff of the U.S. Department of Treasury found that 88 percent of the owners of pass-through entities and sole proprietorships own businesses that spend less than \$10,000 on payroll or contract labor.⁴

In fact, small-business employers would get only a small slice of the benefit from this tax break. The Treasury study found that only 28 percent of all pass-through income is generated by small businesses that spend at least \$10,000 on labor — the small-business employers that the governor claims to be targeting for assistance.



⁴ Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce, and Richard Prisinzano, "Methodology to Identify Small Businesses and Their Owners," Office of Tax Analysis, U.S. Department of Treasury, August 2011, Table 15.

Another 29 percent is generated by *large* businesses with employees. The largest share of pass-through income, 43 percent, is generated by entities that aren't true businesses and/or don't have employees (other than the owners). (See Figure 1.)

Yet, *all* of this income would be exempt under the Kansas legislative proposals, without any requirement that beneficiaries create — or even maintain — a single job.

Moreover, while small businesses are sometimes described as the engine of the economy, that doesn't mean *all* small businesses create jobs. In fact, many don't. As the Federal Reserve Bank of Kansas City notes:

The attribution of the bulk of net job creation to small businesses arises largely from relatively large job losses at large firms, not to especially robust job creation by small firms. More importantly, data show that, on average, large businesses offer better jobs than small businesses, in terms of both compensation and stability. Further, there is little convincing evidence to suggest that small businesses have an edge over larger businesses in innovation.⁵

A recent article in the trade publication *Tax Notes*, citing several recent studies, adds:

New research shows that small businesses are mainly skilled craftspeople, lawyers, doctors, real estate agents, shopkeepers, and restaurateurs. These businesses provide relatively standardized goods and services for existing customer bases. They are responsible for little innovation. Once they are established, they do not grow. Moreover, they do not want to grow. One major reason for this is that many small business owners are motivated by non-pecuniary benefits such as wanting a flexible schedule or to be their own boss.⁶

There is an exception: Some *young* small companies are responsible for a lot of innovation and job creation, although these are often economically risky and short-lived jobs. As a recent study by economists at the University of Maryland and the U.S. Census Bureau points out, “Policies that favor various simply defined classes of businesses (e.g., by size) and ignore this fundamental dynamic [i.e., the distinction between young, fast-growing firms and more mature small businesses] will likely have limited success.”⁷ This point is particularly applicable to the proposed new tax break. By definition, all businesses start as small businesses; in the process of becoming large businesses, they add jobs. But the proposed tax break is poorly targeted to those young, fast-growing small businesses, for the following simple reason. In those early stages of growth, fast-growing firms tend to make relatively little profit because they are plowing their receipts back into additional plant and equipment, R&D, marketing and hiring more workers. Because the businesses earn little or no profit, the owners would get little or no benefit from the proposed tax break. In other words,

⁵ Kelly Edmiston, “The Role of Small and Large Business in Economic Development,” *Federal Reserve Bank of Kansas City Economic Review*, second quarter, 2007.

⁶ Martin A. Sullivan (Tax Analysts), “When Should Small Businesses Get a Tax Break?” 134 *Tax Notes* 267 (Jan. 16, 2012). See also Erik Hurst and Benjamin Wild Pugsley (University of Chicago), “What Do Small Businesses Do?” unpublished paper, August 2011.

⁷ John Haltiwanger (University of Maryland), Ron S. Jarmin, and Javier Miranda (both U.S. Census Bureau), “Who Creates Jobs? Small vs. Large vs. Young,” unpublished paper, August 2011.

mature small businesses that *aren't* creating jobs will get the tax break; younger small businesses that are creating jobs won't benefit.

Finally, it is worth noting that the exemption would eliminate Kansas taxes on many owners of Kansas pass-through entities who don't reside in Kansas. Kansas will lose the revenue, but these owners will not even have a hypothetical incentive to create jobs in the state because the profit will still be taxed by their home states in most cases.⁸

The Proposed Tax Exemption Would Cost Kansas Money It Needs for Economic Growth

While Governor Brownback and legislative leaders are touting the proposal as a way to energize business and create jobs, it could have the opposite effect. The lost revenue from the exemption would make it harder for Kansas to maintain its schools, roads, and other resources necessary for economic growth. Internal Revenue Service data show that profits from pass-through entities and sole proprietorships (minus losses) represent about 8 percent of the Kansas personal income tax base. This suggests that the exemption could cost the state 8 percent of its income tax receipts — \$245 million in fiscal year 2013. To place this potential revenue loss in context, \$245 million comes close to the governor's proposed spending on corrections (\$269 million), and is equal to his proposed budget for the University of Kansas and the University Kansas Medical Center combined (\$247 million).

The actual revenue loss would likely be even greater, in part because the tax change would create incentives for taxpayers to reclassify other income as pass-through income.

The Exemption Would Make the Kansas Tax System Less Fair and Create an Incentive for Tax Avoidance

The plan to exempt pass-through income from taxes is part of a broader effort to make Kansas' tax code, in the Governor's words, more "level." But, as with the claim that the proposal targets small businesses, the rhetoric doesn't match the reality.

A wage earner would pay more in taxes than a pass-through business owner, even if they have the same earnings (and whether or not the business owner has a single employee). Profits received by the owners of a Kansas C corporation with a handful of owners would be subject to tax, while the profits received by the owners of a Kansas S corporation with the same number of owners would be tax exempt.

This approach is not only inequitable but also could create some incentives and opportunities for tax avoidance. It could prompt some taxable C corporations with relatively few owners to reorganize as pass-through entities even if they had no intention to create additional jobs. It would also tempt taxpayers to reclassify their income or change how they use it. For instance, a business owner might choose to pay himself less salary and give himself more "profits."

⁸ The reason is this: Under current law, non-resident owners of Kansas businesses get a credit against their home state taxes for the Kansas taxes they pay on their pass-through income. No longer paying Kansas taxes on that income would mean they would no longer get the credit and would pay home-state taxes on the full amount.

These are just a few examples of possible avoidance strategies that the new tax break will enable. Since no state has ever offered this provision, it is hard to know what other avoidance strategies may be possible, but there is little reason to doubt that tax lawyers and accountants will seek to exploit it — that is, to use it to identify additional opportunities to avoid paying taxes on income, particularly investment income, that they would otherwise owe. Of course, only those taxpayers who can afford high-priced lawyers and accountants will benefit from this.

Conclusion

In the end, there is little economic rationale for changing the tax treatment of pass-through income. These businesses already have enormous tax advantages due to their immunity from corporate income taxes, even in cases in which they actually are corporations (S corporations) or enjoy virtually all the benefits of corporations (LLCs). The major beneficiaries of such a giveaway are unlikely to be the small businesses and job creators that Governor Brownback or legislative leadership say they are intent on helping. Instead, the benefits would flow in great measure to large, established businesses, some of which don't even have employees. The state would lose a considerable amount of money that could be used to invest in proven and reliable ways to bolster Kansas' economy: improving schools and colleges and supporting families to ensure a skilled, competent workforce, creating a more reliable transportation system, and strengthening other public assets that make the state an attractive place to work and live.