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HIGH-INCOME TAX CUTS SHOULD EXPIRE ON SCHEDULE

Extending Tax Cuts for One or Two Years or Exempting "Small Business" Income Would Be Ill-Advised

By Chuck Marr and Gillian Brunet

Allowing the 2001 and 2003 tax cuts for couples making over $250,000 (and singles over $200,000) to expire on schedule on December 31 represents the best course of action for the budget and the economy. Extending those tax cuts for one or two years, as some have proposed, would be highly ill-advised. It would make it much more likely that Congress would ultimately act to extend the tax cuts indefinitely, increasing deficits and the debt for as far as the eye can see — and thereby adding to the long-term risks that deficits and debt pose to the economy.

Exempting small business income from the scheduled increase in the top tax rates, as some may also propose, would do little for the economy in the short term; only the top 3 percent of people with any business income would benefit.[1] Over the long term, such an exemption would likely *harm* the economy and the budget by encouraging tax avoidance and reducing revenues.

CBO Ranks Extending Tax Cuts as *Least* Effective Stimulus Option

Some argue that now is not the time to allow the 2001 and 2003 tax cuts for high-income households to expire because the economy is weak. But analysis in a recent Congressional Budget Office (CBO) report decisively refutes this argument.[2] CBO examined 11 options to stimulate growth and job creation and found that extending the 2001 and 2003 tax cuts *in general* came in *last* in effectiveness, well behind measures such as boosting unemployment insurance, providing a tax credit for new hires, extending state fiscal relief, and increasing infrastructure spending.[3]

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[1] Unless otherwise noted, we follow the Joint Committee on Taxation's definition of business income, as defined in JCT's letter of April 6, 2009: "For purposes of this analysis, business income consists of income from sole proprietorships (Schedule C); farm income (Schedule F); and income from rental real estate, royalties, partnerships, subchapter S corporations, estates and trusts, and real estate mortgage investment conduits (Schedule E)."

[2] Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011*, January 2010, http://www.cbo.gov/ftpdocs/108xx/doc10803/01-14-Employment.pdf.

[3] One other option — extending relief from the Alternative Minimum Tax — came in only marginally better than extending the 2001 and 2003 tax cuts.

Furthermore, CBO indicated that extending the tax cuts for *high-income households in particular* would rate even *lower* in effectiveness than extending all of the tax cuts. This is because, as CBO explained, "higher-income households … would probably save [rather than spend] a larger fraction of their increase in after-tax income."[4] An economy in a recession or the early stages of a recovery needs more spending, not more saving. That is why putting money into the hands of people who will promptly spend most or all of it, like unemployed workers, is much more effective at spurring economic and job growth than putting money into the hands of high-income people who are likely to save a significant portion of any additional income they receive.

The CBO findings point the way toward sounder alternatives. Policymakers should allow the high-income tax cuts to expire on schedule and use the 2011 proceeds for policies that CBO has found would have a much higher "bang-for-the-buck" in creating jobs and strengthening economic growth, such as extending unemployment benefits and state fiscal relief, increasing infrastructure spending, and a jobs tax credit. Once the economic recovery is secure, the savings from allowing the high-income tax cuts to expire should go entirely for deficit reduction.

Over the long term, allowing the high-income tax cuts to expire on schedule would benefit the economy by making deficits and debt significantly smaller than they otherwise would be. There is a broad consensus among analysts that the large deficits projected for coming decades will reduce economic growth.

Allowing High-Income Tax Cuts to Expire Would Help Budget

The country is on an unsustainable fiscal path. CBO estimates that even in the unlikely event that Congress enacts all of the deficit-reduction proposals in the President's fiscal year 2011 budget, the debt will climb to 90 percent of the gross domestic product by 2020, and annual deficits will be above 5 percent of GDP (and rising) at that time.[5]

If Congress extends the tax cuts for married filers with incomes above $250,000 and single filers with incomes above $200,000 — the top 2 percent of U.S. households — then deficits and debt will be *$826 billion higher* over the next ten years than if it lets them largely expire, as President Obama has proposed.[6] Extending the high-income tax cuts would increase deficits by even larger amounts in subsequent decades. Thus, if Congress extends these tax cuts, the nation's fiscal trajectory will be even worse, and the risks to future economic growth consequently will increase.

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4 CBO, p. 25.

5 Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2011*, March 2010, http://www.cbo.gov/ftpdocs/112xx/doc11280/03-24-apb.pdf.

6 U.S. Treasury 2010 Green Book, p. 152. This includes the costs (relative to President Obama's proposals) of extending the top two marginal income tax breaks, the repeal of the Pease and PEP provisions, and the 15 percent tax rate on income from capital gains and dividends for households with income above the threshold. Note that under the President's proposals, both the Pease provision (the limitation on itemized deductions for high-income taxpayers) and the dividend tax would be weaker than under pre-2001 law but stronger than if current policies were extended. Some $680 billion of the $826 billion increase in the deficit would come from revenue losses. The other $146 billion would come from increased interest payments on the national debt.

One- or Two Years Extension Likely to Lead to Permanent Extension

Some policymakers may propose a blanket one- or two-year extension of all of the 2001 and 2003 tax cuts as a compromise measure. This would be a serious mistake from the standpoint of the budget and the economy.

A one- or two-year extension would merely postpone the critical decision on the ultimate disposition of the high-income tax cuts until the next Congress, when proponents of making those tax cuts permanent are expected to have more votes in support of such a move. Thus, a short-term extension would sharply increase the chances for an *indefinite* extension — which would produce higher deficits as far as the eye can see.

Exempting "Small Business" Income Would Be Unwise

Proponents of extending the high-end tax cuts argue, in part, that allowing them to expire after 2010 would hurt small businesses. If Congress decides not to extend the high-end tax cuts, some of these proponents may seek a special "carve-out" for small business income, under which the top rate on that income would remain at 35 percent when the top rate on ordinary income returns to 39.6 percent.

Such a carve-out would do little to boost economic or job growth. It would, however, encourage substantial tax avoidance and likely carry substantial costs, thereby worsening deficits and debt.

Would Not Generate New Customers

As both the Congressional Budget Office and business trade associations have recently explained, firms will not hire workers or make new investments unless they have — or expect to have — enough customers to justify the increased capacity.[7] Whether a firm's taxes modestly increase or decrease matters much less in this regard than the level of demand for the firm's products or services.

In a recent analysis, CBO noted that some small businesses would profit from an extension of the current top tax rates, but pointedly rejected the argument that Congress should extend these tax cuts to create jobs. CBO explained: "increasing the after-tax income of businesses typically does not create much incentive for them to hire more workers in order to produce more, because production depends principally on their ability to sell their products." [8]

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[7] See, for example: Michael A. Fletcher, "Obama unveils a $33 billion tax-break plan to boost jobs," *The Washington Post*, January 30, 2010, p. A03, http://www.washingtonpost.com/wp-dyn/content/article/2010/01/29/AR2010012900854.html; and "Jobs bill not likely to create many jobs," Associated Press, February 10, 2010, http://www.msnbc.msn.com/id/35334141/ns/business-economy_at_a_crossroads/

[8] Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011*, p. 26, January 2010, http://www.cbo.gov/ftpdocs/108xx/doc10803/01-14-Employment.pdf.

Would Be Poorly Targeted

Most small businesses are just that — small. Their incomes are not high enough to face the top marginal rates. According to the Joint Committee on Taxation, allowing the two top tax rates to return to their pre-2001 levels would have *no impact whatsoever on 97 percent of taxpayers with business income.* Only the top 3 percent of such taxpayers are in the top two brackets.

Those who claim that raising the top rates would seriously harm small businesses also tend to rely on an extremely broad definition of "small business." Because the IRS does not publish specific, satisfactory data on the taxes that small businesses pay, analysts are left to examine various sources of business income that individuals receive. Some analysts define *any* taxpayer who shows *any* business income on a tax return — including passive income that very wealthy investors secure — as a small business. Defining small businesses in this manner greatly overstates the actual number of small businesses, particularly among households with very high incomes.[9]

For example, most Americans would not describe the nation's wealthiest 400 individuals, some of whom are billionaires, as small businesses. Yet the "Top 400" have a great deal of money to invest and consequently receive significant business income — which means that they qualify as "small business owners" under the broad definition of the term. According to the IRS, the Top 400 received *nearly $17 billion* in S corporation and partnership income in 2007 (the most recent year for which we have these data) — an average of *$83 million* apiece.[10] They would benefit very handsomely if this income were taxed at a lower rate than ordinary income. In addition to the wealthiest 400 taxpayers, the following types of individuals are commonly included in the definition of "small business" used in tax debates:

- partners in very large corporate law firms,
- partners in lucrative medical practices, and
- Wall Street bond traders who receive multi-million dollar bonuses and invest some of their income in investment partnerships.

The commonly used definition of "small business" even includes wealthy executives of the nation's largest corporations and financial institutions who rent out their vacation homes.[11]

Would Promote Tax Avoidance

Carving out a lower tax rate for small business income also would give wealthy taxpayers a powerful incentive to reconfigure various business and financial arrangements in order to reclassify

[9] See Chye-Ching Huang and James R. Horney, "Big Misconceptions About Small Businesses and Taxes," Center on Budget and Policy Priorities, Feb. 2, 2009, http://www.cbpp.org/files/8-29-08tax.pdf.

[10] Some 202 out of the 400 taxpayers with the highest adjusted gross income reported net income from partnerships and S corporations. IRS, "The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992-2007," p. 4, http://www.irs.gov/pub/irs-soi/07intop400.pdf.

[11] Such rental income would be filed under Schedule E, causing these individuals to be included in the commonly used definition of taxpayers with small business income.

regular income as small business income. For example, if "pass-through" income (i.e., income from partnerships, sole proprietorships, and S corporations) qualifies for the lower tax rate, the opportunities for wealthy taxpayers to avoid paying the 39.6 percent top rate will be virtually endless.

Even a carve-out just for active income that high-income individuals receive from S corporations would greatly aggravate tax compliance and tax avoidance problems. The Treasury's Inspector General for Tax Administration, the Joint Committee on Taxation, and the Government Accountability Office (GAO) all have noted that S corporation wage compensation is heavily underreported and, correspondingly, distributions of profits from S corporations — which are not subject to payroll taxes — are overreported. The GAO calculated that in 2003 and 2004, S corporations underreported approximately $23.6 billion in wage compensation to shareholders, "which could result in billions in annual employment tax underpayments."

This current compliance problem flows from the structure of the Medicare tax,[12] which applies to the wages and salaries of S corporation shareholders but *not to the shares of the firm's profits* they receive. This gives shareholders an incentive to convert wages to distributions of firm profits (or to understate their wages and overstate the distribution of profits), since every dollar they receive in distributed profits rather than wages saves them 2.9 cents in Medicare taxes. The recently approved health reform legislation increases the Medicare tax, levying a 3.8 percent rate on income above a threshold of $250,000 for married couples and $200,000 for singles, starting in 2013. The increased rate on income exceeding the threshold will apply to investment income as well as wage income, which will generally reduce the incentive for tax avoidance. However, active S corporation income will continue to be exempt from the Medicare tax, increasing the incentive for shifting to that type of income.

Exempting active S corporation income from the scheduled increase in the top tax rates would *more than double* shareholders' incentive to convert wages into distributions or to misreport wages as pass-through income. Every dollar they received or reported in distributed profits rather than wages would save them not only 3.8 cents in Medicare taxes (starting in 2013) but also 4.6 cents in income tax.[13] Congress, instead of addressing an existing tax-compliance problem, would be making it substantially worse.

Would Be Unnecessary

In addition, providing pass-through entities with a lower tax rate ignores the fact that they already enjoy a tax advantage over competitors organized as traditional corporations (known as C corporations): pass-through entities are not subject to the corporate income tax.

Firms often organize themselves as pass-through entities to avoid the corporate tax and reduce their tax liability. They are free to organize, or re-organize, themselves as Schedule C corporations if that becomes more advantageous for them from a tax standpoint.

[12] We focus here on the Medicare tax and not the Social Security payroll tax because the Medicare wage tax base is not capped. Including both the employer and employee shares of the tax (both of which are ultimately born by employees), the current Medicare tax rate is 2.9 percent.

[13] That 4.6 cents represents the difference between the 39.6 percent rate these individuals would pay on ordinary wage and salary income and the 35 percent rate they would pay on their profits.

Finally, history refutes the notion that small businesses would suffer under a 39.6 percent tax rate and need an exemption from it in order to prosper. During the 1990s, when the top tax rates were at the levels to which they are slated to return in 2011, small business employment rose by an average of 2.3 percent — or 756,000 jobs — per year. In contrast, between 2001 and 2006, when tax rates were lower as a result of the 2001 tax law, small business employment rose at only a 1.0 percent annual rate (367,000 jobs per year) — less than half as much.[14] In short, the 1990s tax rates did not deter a robust, job-creating economic expansion, and the lower tax rates after 2001 did not prevent a recovery that proved very disappointing in generating job growth.

[14] Average annual small business job growth (firms with 20-499 employees), calculations based on data from the Small Business Administration and the U.S. Census Bureau.