

The Graduated Income Tax Trap A Tax on Small Businesses

By Nina Weiss and Gregory Sullivan

Introduction

At a time when many small business owners are already struggling from the economic impacts of COVID-19, it is highly risky to enact a tax on such businesses. Within the broader category of small business owners, pass-through businesses, those structured as partnerships, limited liability companies, sole proprietorships and subchapter S corporations, are taxed through the owners' individual returns, and thus could be subject to the proposed 4 percent surtax in Massachusetts. The graduated income tax could become a deterrent to establishing small businesses in the Commonwealth, limiting future growth in the sector, which accounts for the majority of private sector activity in the state.¹

As profitability returns in coming years once COVID-19 restrictions subside, these businesses will face a new burden just as they are recovering from current hardships. New taxes could also deter future entrepreneurs from starting businesses here.

What is the Graduated Income Tax?

For the past several years, Massachusetts has been considering a state constitutional amendment that would levy a 4 percent surtax on annual personal income over \$1 million. The first attempt to do so, filed by initiative petition, failed a Massachusetts Supreme Judicial Court challenge in 2018 before re-emerging as a legislative petition and receiving initial approval at a constitutional convention in 2019. A vote on final approval by the legislature is expected in the spring of 2021. If passed, it will appear on the statewide ballot in the fall of 2022.

Proponents of the amendment, led by the Massachusetts Teachers Association and the Service Employees International Union, together with advocacy and religious groups, call it the "Fair Share Amendment," a nod to their frequent assertions that the measure would require only the very wealthy to pay what proponents believe is their "fair share" of taxes.

Opponents argue that it would endanger the long-term economic well-being of Massachusetts by prompting high-income residents and businesses to relocate to states that have lower income tax rates and discouraging high-income individuals and businesses from coming to Massachusetts in the first place. They believe that COVID-19 may exacerbate these relocation effects, as the pandemic has made telecommuting much more prevalent, at least in the short term.²



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Pass-through businesses overview

Although large, publicly traded corporations like Amazon and Microsoft are perhaps the most visible actors in the US private sector, pass-through businesses account for the majority of private sector income and make up 95 percent of US businesses overall.³ Pass-through businesses include sole proprietorships, partnerships, limited liability corporations and subchapter S corporations.⁴ These types of businesses are taxed at the individual level rather than the corporate level, since pass-through business owners elect to have their enterprises' income flow through their individual tax returns. In contrast, C corporations are subject to corporate income taxes and their owners (shareholders) are taxed separately from the entity.⁵ Owners of pass-through entities avoid the double taxation that occurs when profits are taxed first on the corporate level and again on the individual level as corporate dividends.⁶

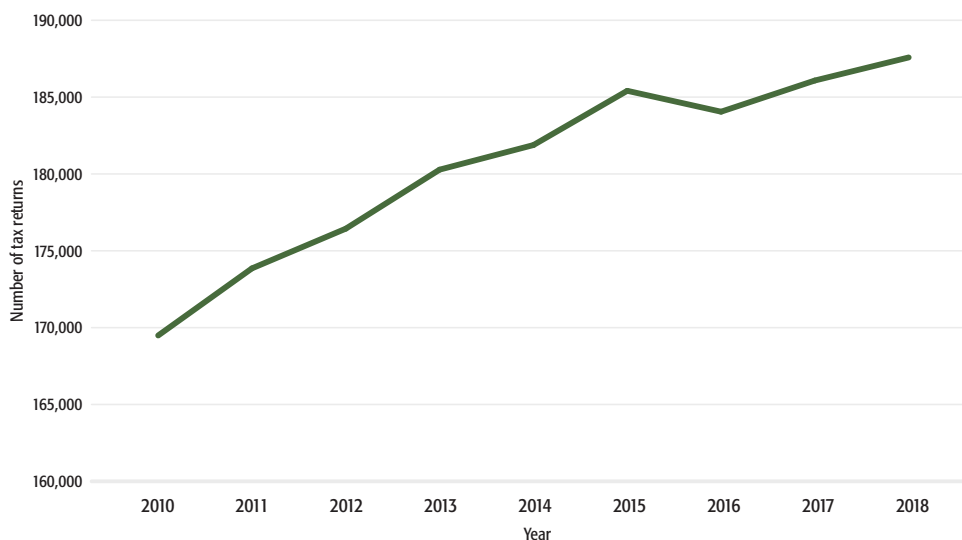
In Massachusetts, 57.1 percent of private sector employees worked for pass-through entities in 2018.⁷ In fact, Hawaii is the only state where pass-through businesses don't account for a majority of private sector employment, and Hawaii also has the fourth-highest marginal tax rate on pass-through entities in the country, behind New York, New Jersey, and California.

Many attribute the sizable growth of pass-through enterprises to a variety of tax reform measures passed in recent decades.⁸ The Tax Reform Act of 1986 made individual tax rates lower than corporate rates, prompting growth in the pass-through business sector. Secondly, the “check-the-box” rule of 1996 allowed businesses themselves to choose whether to be treated as a corporation or a pass-through entity for tax purposes. Prior to the rule change, the IRS determined an entity's tax status via multifactor *Kintner* regulations that enumerated the six characteristics of a corporate venture.⁹ Now that business owners can themselves choose how to be taxed when starting a business, these regulatory changes have led to a sizable increase in both the number of pass-through establishments and their share of overall US employment. The Tax Cuts and Jobs Act of 2017 made such business structures even more attractive by allowing the owners of pass-through entities to deduct up to 20 percent of net business income on their personal returns.

In the decades since the *Kintner* regulations were eliminated, pass-through businesses have played a momentous role in facilitating capital accumulation in the United States. In 2016, the Internal Revenue Service published its most recent comprehensive analysis on the topic, entitled “Sales of Capital Assets Data Reported on Individual Tax Returns, 2007–2012.”¹⁰ The report found that net capital gains from pass-through businesses during this period were by far the largest source of capital gains reported by taxpayers on individual tax returns, totalling \$1.25

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Figure 1: Number of tax returns declaring income from partnerships or S-corporations in Massachusetts, 2010–2018



Source: IRS 2010–2018 SOI Tax Stats Historic Table 2 Individual Income and Tax Data, by State and Size of Adjusted Gross Income. Analysis by Pioneer Institute

trillion, which is 49.8 percent of all capital gains. In comparison, total capital gains from the sale of stocks, mutual funds, and bonds were \$511.44 billion, less than half as much, representing 20.3 percent of all capital gains.¹¹ These facts further demonstrate the momentous influence pass-through businesses have on economic activity in the United States.

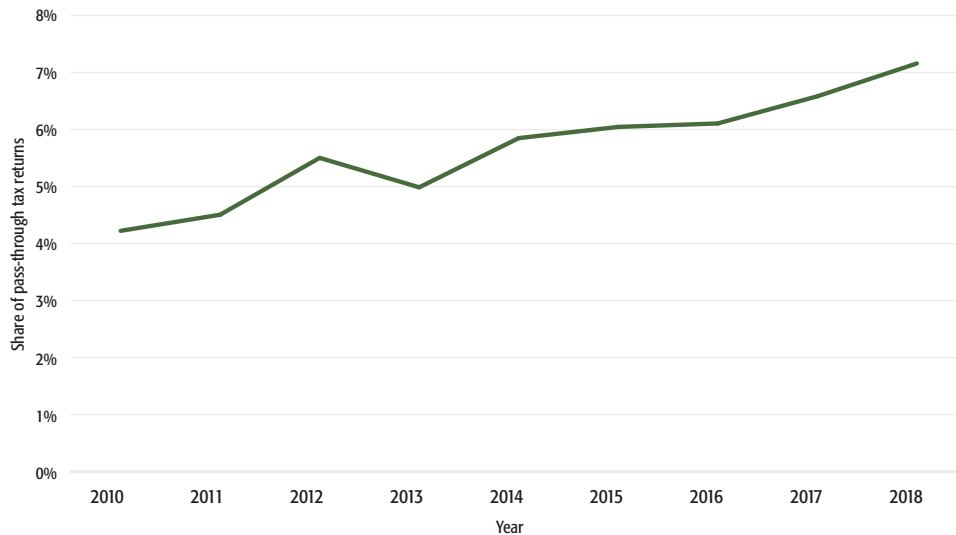
Effects of the graduated income tax on pass-through businesses in Massachusetts

The surtax proposal would have an adverse effect on owners of pass-through businesses, and particularly on sole proprietors. According to the U.S. Census Bureau, sole proprietorship is the most common form of business ownership in the country, representing 41 percent of all businesses, with more than 21 million sole proprietors registered in 2015.¹² The Small Business Administration reports that sole proprietors account for 73.2 percent of U.S. small businesses.¹³ The income and capital gains earned by these businesses could become subject to the proposed surtax because it is taxed as pass-through income to the owner.

Mirroring national trends, Massachusetts has also seen growth among pass-through businesses in recent years (Figure 1). According to IRS tax data, there were 187,580 total partnerships and S corporations in Massachusetts in 2018, a marked increase from 169,490 in 2010. Further, as Figure 2 shows, the share of pass-through entities in the Commonwealth with adjusted gross income over \$1 million has also risen in recent years. These are the entities that would be subject to the proposed surtax. Therefore, based on 2018 data, the surtax may apply to as many as 13,430 businesses, or 7.16 percent of total partnerships and S corporations in Massachusetts, depending on the number of owners to which each entity allocates profit.

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Figure 2: Share of Massachusetts partnership and S-corporation tax returns reporting at least \$1 million in income, 2010–2018



Source: IRS 2010–2018 SOI Tax Stats Historic Table 2 Individual Income and Tax Data, by State and Size of Adjusted Gross Income. Analysis by Pioneer Institute

Both overall growth and the growth of high-earning pass-through firms suggest that Massachusetts has had a friendly business climate for smaller proprietors in recent years. But there are no guarantees that the trends exhibited in these graphs will continue if the surtax passes, as the academic literature and qualitative evidence from nearby states suggest.

One study of 6,817 tax returns that included schedule C from 1985 and 1988 found that higher income taxes lowered firms' gross receipts.¹⁴ The study chose to assess these years since the Tax Reform bill in 1986 significantly altered the tax environment, and the authors wanted to

An individual's decision to enter into a sole proprietorship is a function of the overall individual tax rate.

test whether reducing individual tax rates would prompt greater entrepreneurship. Their results suggest that an individual's decision to enter into a sole proprietorship is a function of the overall individual tax rate. Massachusetts' proposal to implement a surcharge on individual incomes over \$1 million is particularly concerning for the future of pass-through entities in the Commonwealth because of fears that higher individual rates would correspond with fewer pass-through firms.

A different study, this one of macro-level economic data for European countries, found that, controlling for other variables, there is a negative relationship between average and marginal tax rates and entrepreneurship.¹⁵ Further, the study looked at the relationship between tax progressivity and entrepreneurship by income and found that, for those making significantly above average incomes, greater tax progressivity exhibited a statistically significant negative relationship with entrepreneurship. For individuals who made less than average incomes, there was a positive relationship between tax progressivity and entrepreneurship.

The finding about less entrepreneurship among high-income individuals seems particularly relevant when thinking about the proposed graduated income tax. Given that higher income individuals will be affected by the surtax, it could discourage them from establishing pass-through businesses in the Commonwealth.

In other states that have either tried to or enacted income tax hikes, small business groups have been vocal about the negative consequences of the tax increases. In Connecticut, for example, business groups objected to proposals to raise income taxes in 2019. Since the 2019 proposal came on the heels of a 2018 law that altered taxation on pass-through entities, business groups worried that additional changes to pass-through taxation laws would reduce the state's small business hiring rates and overall competitiveness.¹⁶ The executive director of the Connecticut Society of CPAs, Bonnie Stewart, argued that "raising taxes by \$50 million and changing a complex policy just one year after adoption could discourage owners from adding jobs, expanding product lines or services, or from purchasing new equipment."¹⁷ Farmington-based CPA Robert Lickwar added that his clients have been vocal in opposing the 2019 bill and that he worried the proposal would deter "new businesses from locating here."¹⁸

New Jersey business groups also worried about the effects of income tax hikes on pass-through businesses. After many years of trying, the state passed a millionaires tax in September 2020.¹⁹ When the millionaires tax was debated in 2019, prior to its passage, Michele Siekerka, the New Jersey Business and Industry Association's president and CEO, argued that a tax hike on annual income over \$1 million would negatively impact "more than 4,000 small businesses whose owners pay taxes on business income through their personal tax returns."²⁰ A Tax Foundation analysis of New Jersey's recently enacted millionaires tax argues that in a time "when many businesses are struggling to survive and meet payroll, cutting into the profits of businesses that *are* staying afloat is the opposite of an economic recovery strategy."²¹ The Tax Foundation already ranks New Jersey as the least competitive state on their State Business Tax Climate Index, and its recent tax increase seems likely to further erode the state's competitiveness.²²

These anecdotes from Connecticut and New Jersey should concern Massachusetts residents. In 2018, 17,534 Massachusetts taxpayers had both incomes over \$1 million and either Schedule C or Schedule E income, which income often comes from pass-through businesses.²³ This is substantive evidence that the proposed surtax could harm some of the Commonwealth's most entrepreneurial and innovative residents.

Survey data suggests that small businesses are particularly sensitive to changes in personal income tax rates. In the aftermath of the passage of the Tax Cuts and Jobs Act of 2017, the National Federation of Independent Businesses found that 83 percent of independent business owners regarded that law's changes to the personal income tax brackets and rates as either very or somewhat important to them and their businesses. That's a larger share of business owners than said the same for the TCJA's creation of the small business income tax deduction, lowering of the corporate income tax rate, changes to the alternative minimum tax, and all other tax changes about which the NFIB asked.²⁴

"When many businesses are struggling to survive and meet payroll, cutting into the profits of businesses that are staying afloat is the opposite of an economic recovery strategy."

– Tax Foundation

Finally, among the various pass-through entities that could be affected by the surtax are restaurants and hospitality firms. Pioneer previously explored the acute impact of the COVID-19 pandemic on restaurants, retail, and hospitality firms, and it seems possible that the graduated income tax could pose an additional burden for high grossing firms in these sectors.²⁵ Although there does not seem to be any data on the precise number of restaurants or hospitality enterprises in Massachusetts that are pass-through businesses with more than \$1 million in income, it is reasonable to assume that even these higher grossing entities have struggled during COVID-19. Thus, it would be both risky and unfair to subject these businesses to a new tax once they begin to recover, which could be as late as 2023, precisely when the surtax—if passed—would kick in.²⁶

Conclusion

In sum, the graduated income tax would not only hit Massachusetts' highest-paid corporate executives, but it would also hit successful independent business owners who elect to form their businesses as pass-through entities. In recent years, the Commonwealth has seen growth in the number of pass-through businesses overall and of those that would be subject to the surtax. But as qualitative anecdotes from Connecticut and New Jersey suggest, if the surtax becomes law, it could barricade the future growth of pass-through businesses in Massachusetts.

Finally, at a time when so many small business owners, including those who run pass-through establishments, are hurting from the economic damage brought on by the COVID-19 pandemic, Massachusetts leaders should be as accommodating as possible to smaller proprietors. Policy should strive to accelerate business growth, not to hamper it.

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