



Minnesota Budget Project **Few Small Business Owners Would Be Impacted by Income Tax Increases on High-Income Households**

No business or individual alone can provide for an educated workforce or safe roads and bridges. Taxes pay for these essential services. The House and Senate omnibus tax bills increase the income tax rate on the highest-income households as part of budget-balancing packages that also include spending cuts. This has raised the question of how small businesses will be affected by income tax increases.

An analysis of a new 4th income tax bracket for taxable income above \$250,000 found that **only 5.7% of households with small business income** would be in the new tax bracket.¹ While only a small number of households with small business income fall into the 4th income tax bracket, 62 percent of households in that bracket have at least \$1 of small business income.²

Small Businesses are Taxed at the Owner or Shareholder Level

There is no universal definition of “small business,” but for tax purposes, it means that the business is taxed at the owner or shareholder level through the individual income tax. In contrast, corporations (C-Corps) are taxed at the corporate level and are subject to the corporate franchise tax.

A small business can have one of several ownership structures, as a partnership, sole proprietorship, subchapter S Corporation (S-Corp) or a Limited Liability Company (LLC).³ Each year, the business fills out a statement of profit and loss that shows the business’ net profit, if any. The profit is then reported to the owners and/or shareholders. The owners, in turn, report this “passthrough” income on their federal and state income tax returns. (S-Corporations and LLCs also pay an entity level fee that ranges between \$100 and \$5,000.)⁴

For example: John Q. Public owns a lawn service business, which is organized as a sole proprietorship. He earns gross income of \$200,000. When he files his individual income tax return, he can deduct many business expenses from this gross income, including car expenses, licenses and fees, contract labor, health insurance, depreciation on purchased equipment, office expenses, rent, repairs, travel, business meals and entertainment, and pension plan contributions. If he has employees, he can also deduct their wages and employee benefit costs. After these deductions, he reports a net profit of \$50,000 as income, and pays individual income tax on that \$50,000 – just as a salaried worker would.

Taxes are Just One of Many Factors that Drive Business Activity

Concern around the impact that tax rate changes will have on business activity seems to assume that state taxes represent a large cost of doing business and can hurt job creation. However, research on the connection between state taxation and business activity is much less conclusive. For example, a study commissioned by the United States Small Business Association found that state tax policy, including both tax rates and the type of taxes in a state’s portfolio, has only a modest effect on small business creation.⁵

The world and the economy is complex. Many factors determine small business activity, such as the personal situation of the small business owner, the health of the economy, and regulations. In fact, health care costs regularly place higher than taxes as a barrier to business growth in surveys of businesses. As policymakers consider tax proposals, they should remember that taxes are just one component of the business climate.

¹ This proposal, contained in House File 885, would impact taxable income above \$140,000 for single filers and \$212,500 for head of household filers. Minnesota Department of Revenue. This analysis is of full-year resident tax filers who have income from S-corps, partnerships, sole proprietors or farms.

² 30 percent of taxfilers in this income group count on small business income for 20 percent or more of their income.

³ An LLC can choose to be taxed as a C-Corporation, an S-corporation or as a sole proprietor.

⁴ Center on Budget and Policy Priorities, *Reforming the Tax Treatment of S-Corporations and Limited Liability Companies Can Help States Finance Public Services*, April 8, 2009.

⁵ Donald Bruce and John Deskins, *State Tax Policy and Entrepreneurial Activity*, November 2006.