SBLC WEEKLY

SMALL BUSINESS LEGISLATIVE COUNCIL

Via E-mail
March 2, 2009 Volume XI, Issue 10

STUCK IN THE MIDDLE WITH YOU

"Here I am, stuck in the middle with you", sang the Stealers Wheels in their 1972 song. We would add "again."

The President has proposed reinstating in 2011 the two top rates for individuals when the 2001 tax rate cuts expire. In 2009, married taxpayers with income over $208,850 but not over $372,950 will pay $46,741.50 plus 33 percent of the excess over $208,850; and married taxpayers with income over $372,950 will pay $100,894.50 plus 35 percent of the excess over $372,950.

In his Fiscal Year 2010 proposed budget, the President has recommended to Congress that they reinstate the 36 percent and 39.6 percent rates for those taxpayers earning over 250,000 (married) and $200,000 (single).

Once again, the discussion is about exactly how many small businesses are affected by the change. Sole proprietors, partners, and S Corporation shareholders pay taxes on business income through the individual income rate schedules. These are generally referred to as "pass-through" entities.

The debate over "how many small businesses are affected" is similar to one surrounding the estate tax. We had long moved off the argument about the taxes that are actually paid. It is often more about those that potentially would have to pay the tax and the effect on their behavior.

On one side, we have the Center for Budget and Policy Priorities:

"Some critics of the President's budget charge that his proposals to roll back tax breaks for taxpayers with incomes over $250,000 would harm small businesses. In fact, only 8.9 percent of people with any small business income have incomes of over $250,000 and, thus, would even potentially be affected by these provisions. And that figure substantially overstates the percentage of people with small business income who would actually be affected by these provisions; for example, only 1.9 percent of people with such income currently are in a tax bracket with a rate higher than 28 percent."

"The statistics cited in this paper adopt the Bush Administration's definition of a small business as any tax unit that receives any income (or loss) from a sole proprietorship, farm proprietorship, partnership, S corporation, or rental income… that definition of 'small businesses' is more likely to include high-income taxpayers who do not conform to the typical conception of a 'small business owner' than it is to erroneously count low-income taxpayers, due to the increasing prevalence of passive investment income at higher income levels."

On the other side, we have the Small Business Legislative Council:

"While statistics cited in debates about the impact of tax rate cuts or increases generally rely on the number of taxpayers at certain taxable income levels compared to the aggregate number of small businesses, we believe it is relevant to look at the number of pass-through entities that have gross receipts in the $250,000 and up range as businesses that are concerned about the top marginal rate. Whether profitable or not, their gross receipts make them viable candidates. Roughly three million businesses fall in that category(using 2005 data). If you add the number of small businesses in the gross receipts bracket just below that, the number jumps by another two million."

2005	**Sole Proprietor ships**	**Partner ships**	**S Corps**
Firms by gross receipts	Number of Returns	Number of Returns	Number of Returns
$100,001 to $250,000	1,529,599	183,111	691,466
$250,001 to $500,000	526,512	134,754	508,854
$500,001 to $1,000,000	232,070	102,843	413,544
$1,000,001 to $10,000,000	113,811	168,440	544,938
$10,000,001 to $50,000,000	2,427	22,306	62,882
More than $50,000,000	225	6,658	12,862

1100 H Street N.W., Suite 540 Washington, DC 20005 / (202) 639-8500 / Fax: (202) 296-5333 / www.sblc.org

"Equally important, is the fact these are the small businesses that will lead us out of the economy situation, if we give them a chance. A large segment at the heart of the 'engine,' as the small business community is often characterized, are those small businesses that are successful enough to be taxed at the top individual margin rate. These are the businesses that provide meaningful jobs, innovate, and provide the economic diversity that is essential to stable local communities"

Here's the irony for us. While it is our preference the rates are not increased, if you did not go after every penny of taxes, you could easily take small business out of this debate. Approximately 0.2 percent of partnerships with gross receipts in excess of $50 million report 67 percent of all partnership gross receipts. For S corporations, 0.35 percent of S corporations with gross receipts in excess of $50 million report 34 percent of S corporation gross receipts. At $10 million in gross receipts, those numbers are one percent of partnership report 80 percent of the gross receipts and two percent of S Corporation report 55 percent of the gross receipts. The number of sole proprietors at either level is negligible.

BUDGET PROCESS

Bear in mind, President Obama is only making a budget request to Congress. At this point in the process, he has only the bully pulpit to influence the debate. The President's real influence is at the back end of the process when he can veto appropriations or tax bills.

Everything in between is totally at the discretion of Congress. They choose to pass a budget resolution or not. If they do, it does not require a presidential signature.

This budget request is for Fiscal Year 2010. This week Congress is trying to finish up the Fiscal Year 2009 funding. You may recall the 110th Congress failed, as many Congresses have, to fund the government before the beginning of the fiscal year. Only a handful of appropriations bills were passed. The 110th Congress passed a continuing resolution for the rest of the government and that resolution expires at the end of this week.

It is not likely this Congress will consider the President's budget request in a holistic fashion.

ESTATE TAX

The President's budget request does contemplate that the estate tax exemption would be "frozen" at the 2009 level of $3.5 million and the top rate would be "frozen" at 45 percent. It does not appear to contemplate "indexing for inflation."

Of all the tax items in the budget request, this might be the best candidate for resolution within the budget process. If Congress provides reconciliation instructions, it would avoid a 60-vote showdown in the Senate. We are expecting the instructions would still require Congress to find offsetting revenues elsewhere.

ALTERNATIVE MINIMUM TAX

One of the interesting proposals in the President's budget request is to make the current temporary Alternative Minimum Tax (AMT) income level "patch" permanent at 2009 levels with indexing for inflation in future years. For a Congress looking to get out of the patch business, this might be the exit strategy.

LIFO ACCOUNTING REPEAL

The President's budget request calls for repeal of the LIFO (Last In, First out) Accounting Method in 2012. This is a "smoke'em if you got them" kind of issue. If you use the method, this is of huge concern to you.

For those not familiar with LIFO, the LIFO method assumes the items of inventory you purchased or produced last are the first items you sold, consumed, or otherwise disposed of. Items included in closing inventory are considered to be from the opening inventory in the order of acquisition and from those acquired during the tax year.

Typically, a business carries a LIFO reserve on its books that reflects the amount of taxable income that has been "deferred" by using the method. This amount reflects the difference between what the dollar value of the inventory would have been under FIFO and the LIFO value.

This is not a new exotic accounting structure. This method has been explicitly allowed in the tax code since 1938. In fact, long ago, the government encouraged its use.

If the LIFO method is repealed, the LIFO reserve is eliminated and the taxable income is increased immediately and taxes are owed. Usually, when taxpayers convert from LIFO, the tax can be paid over a four year period under change of accounting rules. Discussions about LIFO repeal usually include some discussion of a firm and longer transition rule to stretch out the period in which the business has to pay the accrued tax liability. For a small business that has used LIFO for a long time (think multi-generational family business), the reserve number can be huge.