SMALL BUSINESS
LEGISLATIVE
COUNCIL

TAX RATES AND SMALL BUSINESS

STATUS

The American Taxpayer Relief Act (ATRA), Public Law 112-240, has created a new permanent personal tax rate structure. Brackets are adjusted for inflation.

The new brackets for 2013 tax year, for an unmarried individual, are:

- Not over $8,925: 10% of the taxable income
- Over $8,900 but not over $36,250: $892.50 plus 15 percent of the excess over $8,925
- Over $36,250 but not over $87,850: $4,991.25 plus 25 percent of the excess over $36,250
- Over $87,750 but not over $183,250: $17,891.25 plus 28 percent of the excess over $87,750
- Over $183,20 but not over $398,350: $44,603.25 plus 33 percent of the excess over $183,250
- Over $398,350 but not over $400,000: $115,86.25 plus 35 percent of the excess over $398,250
- Over $400,000: $116,163.75 plus 39.6 percent of the excess over $400,000

There is a phase out of itemized deductions based on hitting a certain income threshold.

ANALYSIS AND BACKGROUND

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. 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.
C Corporations pay taxes at the corporate level.

As the weeks leading up to the fiscal cliff demonstrated, their ranks are bolstered by those small business owners who aspire to reach that plateau.

Answering the question, "How many small businesses are there?" has always been a double-edged sword. In aggregate, it is an important segment of our nation's economy. However, as we have learned over our many years of experience, the aggregate number can be used to overstate or understate the impact of a specific policy upon small business. Our experience is that you have to look more closely at specific segments of the small business sector on a policy by policy basis. Using available tax data for 2009, the composition of the business community for tax purposes looks like this:

Nonfarm Sole Proprietors	C Corporations	S Corporations	Partnerships	Farms	Total
22.6 Million	1.8 Million	4.2 Million	3.1 Million	1.9 Million	33.6 Million

(For federal tax purposes, most Limited Liability Companies (LLCs) elect to be taxed as partnerships whether they choose to organize like a corporation or partnership and they are included in the partnership column. There were just under 2 million LLCs –the bulk as Corporations and a small fraction (roughly 100,000) as Partnerships.)

It is the large number of sole proprietorships that constitute the "grey" area of "what is a small business." The number is derived from the number of individual tax returns that include a Schedule C form upon which individuals report income derived from business activity. This can be anything from a few dollars to millions of dollars. **In 2009, seventy percent of the sole proprietorships had less than $25,000 in gross receipts.** Distinguishing between occasional part-time income producing activity and attempts to maintain a viable business, even on a part-time basis, is difficult at the low gross receipts levels.

According to data from the Joint Committee on Taxation using IRS data:

Distributing by number of returns, for C corporations, the three most prevalent industries are services, retail trade, and construction. These three industries account for approximately 33 percent of all C corporations. For S corporations, the three most prevalent industries are services, construction, and real estate. These three industries account for approximately 41 percent of all S corporations. For entities taxed as partnerships, the three most prevalent industries are real estate, finance and insurance, and services. These three industries account for approximately 64 percent of all partnerships.

Distributing by assets, for C corporations, the three largest industries are finance and insurance, holding companies, and manufacturing. These three industries account for more than 83 percent of all assets reported by all C corporations. For S corporations, the three largest industries are holding companies, construction, and manufacturing. These three industries account for 37 percent of all assets reported by all S corporations. For partnerships, the two largest industries by far are finance and insurance and real estate, followed by manufacturing at a distant third. These three industries account for more than 81 percent of all assets reported on all partnership returns.

C corporations with over $50 million in total receipts, which represent approximately 1 percent of all C corporations, collect 88 percent of total receipts of all C corporations. For partnerships, the approximately 0.2 percent of partnerships with total receipts in excess of $50 million report

67 percent of all partnership total receipts. For S corporations, 0.3 percent of S corporations with total receipts in excess of $50 million report 35 percent of S corporation total receipts. For nonfarm sole proprietorships, less than 0.002 percent of such businesses report total receipts in excess of $50 million, and these businesses report about 6 percent of all nonfarm sole proprietorship total receipts.

The composition of the sole proprietor universe by number of returns (2008 data) looks like this:

Selected Sectors	Number of Schedule Cs
Construction	**2,821,700**
Specialty Trade Contractors portion	2,263,300
Wholesale Trade	**325,000**
Retail Trade	**2,427,500**
Non-store retailer portion	983,191
Miscellaneous Store Retailers portion	519,027
Real Estate	**1,278,900**
Transportation and Warehousing	**1,047,700**
Finance and Insurance	**693,100**
Professional, Scientific, and Technical	3,218,900
Legal Services portion	378,111
Accounting Services portion	357,597
Architectural, engineering portion	255,567
Management, scientific, technical consulting portion	950,327
Administrative and Support	**2,302,800**
Health Care and Social Assistance	**1,998,300**
Ambulatory Health Services (e.g. doctors' offices) portion	990,181
Child Care portion	788,400
Arts, Entertainment and Recreation	**1,347,800**
Other Services	**2,360,100**
Personal & Laundry Services portion	1,497,900
All Other Industries	**2,939,200**

PASS-THROUGH ENTITIES AND MARGINAL RATES

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 at least 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 even though gross receipts do not translate to taxable income. Whether profitable or not, their gross receipts make them viable candidates. Roughly, 2.8 million businesses fall in that category.

Gross Receipts size - 2009	Nonfarm Sole Proprietors	Partnerships	S Corporations
0 or less	1,160,757	1,973,890	585,057
$1 to $25,000	14,880,129	277,363	483,230
$25,001 to $50,000	2,688,913	116,689	289,109
$50,001 to $100,000	1,794,080	137,478	419,156
$100,001 to $250,000	1,358,320	206,261	725,174
$250,001 to $500,000	454,209	132,726	523,936
$500,001 to $1,000,000	207,854	117,055	449,734
$1,000,001 to $10 Million	112,712	176,841	543,884
$10,000,001 to $50 Million	2,606	23,394	65,093
More than $50Million	395	7,029	12,190

*Figures might not add up due to rounding

THE S CORPORATION MIGRATION

After the passage of the 1986 Tax Reform Act, there was a migration of C Corporations to S Corporation status. There are two provisions of law that apply if the corporation was previously a C corporation and are intended to prevent avoidance of otherwise applicable C corporation tax consequences.

First, an S corporation is subject to tax on excess net passive investment income, if the corporation has subchapter C earnings and profits and has gross receipts more than 25 percent of which are passive investment income for the year.

Second, for the first 10 years after a corporation that was previously a regular C corporation elects to be an S corporation, certain net "built-in" gains of the corporation attributable to the period in which it was a C corporation are subject to tax at the top corporate rate. This basically requires a tax to be paid on the previously untaxed appreciation of the assets including receivables, goodwill, and inventory that are transferred.

C CORPORATIONS

There are approximately two million C Corporations.

The income of a C corporation is taxed directly at the corporate level. Shareholders are taxed on dividend distributions of the corporation's after-tax income (the dividend is not deductible by the corporation.) Shareholders are also taxed on any gain (including gain attributable to undistributed corporate income) on the disposition of their shares of stock of the corporation. As a result, the income of a C corporation may be subject to tax at both the corporate and shareholder levels.

C corporations are taxed at statutory rates ranging from 15 percent (for taxable income up to $50,000); 25 percent (for taxable income above $50,000 but not exceeding $75,000); 34 percent (for taxable income above $75,000 but not exceeding $10,000,000); and to 35 percent (for taxable income over $10,000,000). The benefit of graduated rates below 34 percent is phased out for corporations with taxable income between $100,000 and $335,000, and the benefit of the 34 percent rate is phased out for corporations with taxable income in excess of $15,000,000. Corporate long-term capital gains are taxed at the same rates as corporate ordinary income. Thus, the maximum tax rate for corporate net long-term capital gains is 35 percent.

In addition to the regular corporate tax, the Code provides for an additional tax paid by the corporation at the top individual rate, imposed on certain corporate earnings that are not distributed to shareholders. An "accumulated earnings tax" can be imposed on certain earnings in excess of $250,000 ($150,000 for certain service corporations in certain fields) accumulated beyond the reasonable needs of the business.

C corporations with over $50 million in gross receipts, which represent approximately 0.86 percent of all C corporations, collect 85 percent of gross receipts of all C corporations.

CAPITAL GAINS AND DIVIDENDS RATES

ATRA made the changes established by 2003 law permanent with one change – increasing the top rate for capital gains and dividends.

For taxable years beginning January 1, 2013, generally, the maximum rate of taxation on the adjusted net capital gains of an individual is 20 percent for individual taxpayers with taxable income over $400,000 ($450,000 for married couples). It remains at 15 percent for incomes below that level except any adjusted net capital gains which otherwise would be taxed at a 10- or 15-percent rate are taxed at a zero rate.

Under long time "temporary" law, an individual's qualified dividend income was taxed at the same rates that applied to net capital gains. This treatment applied for purposes of both the regular tax and the alternative minimum tax. Thus, an individual's qualified dividend income was taxed at rates of zero and 15 percent. The zero-percent rate applied to qualified dividend income which otherwise would be taxed at a 10- or 15-percent rate if the special rates did not apply.

Effective January 1, 2013, the dividends rates link to the capital gains rates continues, so for taxable years beginning January 1, 2013, an individual's qualified dividend income is taxed at rates of zero, 15 percent or 20 percent depending on income levels.

Dividend rate reductions for shareholders "mitigate" some of the impact of the fact the dividends are not deductible by the corporation.

ALTERNATIVE MINIMUM TAX

Not included in this discussion is the impact of the Alternative Minimum Tax (AMT). On the C corporation side, there is an exemption for corporations with gross receipts of less than $7.5 million. On the individual side, the thresholds are much lower. We now have a permanent patch that adjusts the individual thresholds for inflation, however, in a tax reform context, the personal AMT is still a problem for profitable small businesses.

The levels that apply to your 2012 income are $78,750 for married couples filing jointly and $50,600 for individuals. For 2013, the amounts are $80,800 and $51,900 respectively.

EFFECTIVE RATE OF TAXATION

A marginal rate is the rate at which the last dollar of income is taxed. If the discussion expands to a broader discussion of tax reform, then effective rate of taxation is important. Technically, in the tax economists' world, the phrase is the average rate of taxation (taxes paid divided by taxable income.) When they refer to average effective rate, it is taxes divided by a broader definition of total "economic" income. We are not tax economists and for a discussion of what elements of the tax code and structure are important to small business, we use the term "effective rates" and we mean taxes paid divided by taxable income.

There are countless deductions, credits and other factors that determine a business' effective rate of taxation by virtue of their adjustment of taxable income.

OUTLOOK

To provide small business peace of mind, where would you draw the line? The $50 million gross receipts level, as described above, still "catches" most of the taxable income. Indeed, on the corporate side, a similar line can be drawn. At $10 million, one would "capture" more of the taxable income but it might still be within the range of tolerance in terms of number of small businesses affected by it. This is annual taxable income. Even at $1 million, you have provided the legitimate peace of mind while maintaining most of the revenue stream.

Unfortunatley, some small businesses are caught up in the need for revenue and balancing business and personal taxes. Hopefully, some of these concerns can sorted out in the tax reform discussions.