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House Bill to Hit Small Businesses with Surtax

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As unemployment continues to rise, it is unfortunate and surprising that many policymakers are taking steps to *reduce* employment. The large tax increases proposed by House Ways and Means Chairman Charlie Rangel (D-NY) would harm over a million small businesses, making them less likely to expand and hire new workers. Congress should not pass large tax increases on businesses that would hinder employment.

Rangel Surtax Impact. The surtax is 1 percent for joint filers over \$350,000, 1.5 percent for joint filers over \$500,000, and 5.4 percent for joint filers with over \$1 million in adjusted gross income (\$280,000, \$400,000, and \$800,000 for individuals, respectively). The Joint Tax Committee estimates that the Rangel surtax will raise \$543.9 billion over the next 10 years.¹

Congress also surrenders its prerogative to make tax policy by letting bureaucrats in the executive branch set future tax rates. If the President's Office of Management and Budget determines that promised savings have not arrived, then the tax rates will go up automatically to 2 percent and 3 percent for those making \$350,000 to \$1 million. Businesses will have a hard time planning for the future with such variable tax rates.

Approximately 2 million tax filers will be hit by the surtax, with the majority of them being joint filers. Sixty percent of these returns report having positive small business or partnership income. Over 400,000 tax filers report that over half of their adjusted gross income is from small business or partnership income. This small share of taxpayers

already pays a disproportionate share of the federal income tax, paying a fourth of the total income tax, despite being less than 1 percent of all tax filers.

The surtax, when combined with the expiration of President Bush's tax cuts and various state and local taxes, lifts the marginal rates on small business to over 50 percent in most states. This is a 10-percentage-point increase in the marginal tax rate and over a 28 percent increase in the top marginal tax rate. The top tax rate is higher than almost all other industrial nations.

"Income shifting" to take advantage of tax rate differences was a common practice until tax reform in 1986, which reduced the financial incentive to shift income or engage in tax shelters. With the Rangel surtax, the top rate on individuals would lead to a difference of over 10 percentage points between the corporate tax rate and the individual tax rate. Many partnerships would then be likely to incorporate, which would increase corporate tax revenue but lower individual income tax revenue.²

Small Businesses' Ability to Create Jobs Will Be Harmed. Small business is the backbone of the American economy. Half of all private workers in the U.S. are employed in firms with fewer than 500

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workers.³ These small firms have also created 60–80 percent of all new jobs in the last decade.⁴

Higher tax rates discourage investment in small business by increasing the hurdle rate for investors—i.e., the cost of a new project that must be exceeded to generate a profitable return on an investment. Higher hurdle rates mean that fewer small businesses will be created and fewer existing businesses will expand.⁵

In addition to the surtax, the House health care bill would force small businesses with at least \$250,000 in payroll to provide health insurance or pay a tax penalty up to 8 percent of payroll. Almost all small businesses and employees would be affected: Over four-fifths of all small businesses employees are in firms with more than nine employees, and almost all firms with 10 or more workers have more than \$250,000 in payroll.

The mandate increases the marginal cost of each additional worker, making it less likely that small businesses will hire new employees or give raises to existing ones in a weak economy. While small businesses will pass on many of the cost increases to employees, employment will be especially harmed in cases where businesses cannot pass on the cost increases to customers or investors.

This tax increase is estimated to be \$163 billion over 10 years and another \$45 billion in payments to health exchanges.⁶ This \$208 billion in costs will

be paid through lower wages for existing employees, a reduction in hours worked, and fewer new workers hired.

It is estimated that 32 million employers will offer health insurance as a result of this legislation.⁷ This means that 32 million companies will either raise the prices of their goods, reduce wages to maintain the same overall level of compensation, or cut jobs and work hours.

The Wrong Policy at the Wrong Time. Small businesses, like all businesses, will be reluctant to hire in an unstable fiscal atmosphere. Businesses will be unable to ascertain if they will face a potential top federal income tax rate of 35 percent, 39.6 percent, or 45 percent. The employer mandate adds to the uncertainty of what their payroll costs could be. These uncertainties, when coupled with the macroeconomic environment, provide reasons for small businesses to delay hiring as long as possible.

The Rangel surtax and the expiration of the Bush tax cuts means that the top marginal rate would increase by over 28 percent in the next two years. Much of this burden will fall on small businesses, which will pass those costs onto consumers, employees, or both. This policy is exactly what the backbone of the American economy needs the least.

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2. Len Berman, “Alan Reynolds and TPC Corporate Tax Estimates,” TaxVox, at http://taxvox.taxpolicycenter.org/blog/_archives/2008/11/10/3971379.html (July 22, 2009).
3. U.S. Small Business Administration, Office of Advocacy, based on data provided by the U.S. Census Bureau, Statistics of U.S. Businesses
4. Source: U.S. Dept. of Commerce, Bureau of the Census and International Trade Administration; Advocacy-funded research by Kathryn Kobe, 2007 (www.sba.gov/advo/research/rs299tot.pdf) and CHI Research, 2003 (www.sba.gov/advo/research/rs225tot.pdf); Federal Procurement Data System; U.S. Dept. of Labor, Bureau of Labor Statistics
5. Norbert Michel, “Everyone Profits from Hurdling Dividends,” Heritage Foundation *WebMemo* No. 248, April 3, 2003, at <http://www.heritage.org/Research/Taxes/wm248.cfm>.
6. Congressional Budget Office, “Preliminary Analysis of the Insurance Group Coverage Specifications Provided by the House Tri-Committee Group,” July 14, 2009, at http://cbo.gov/ftpdocs/104xx/doc10430/House_Tri-Committee-Rangel.pdf (July 22, 2009).
7. *Ibid.*