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Student Loan Payroll Tax Increase: Another Attack on Small Business

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President Obama is campaigning heavily for Congress to prevent the lapsing of a special low-interest rate on student loans. Specifically, unless deferred, the interest rate will rise from 3.4 percent to 6.8 percent on federal Stafford student loans issued after July 1.[1]

Senate Majority Leader Harry Reid (D–NV) has proposed to offset the cost of continuing to subsidize these loans by raising taxes on small businesses to the tune of $9 billion over 10 years.[2] This is the latest in a series of tax increases on small businesses pursued by both President Obama and Reid. It would set a dangerous tax policy precedent that Congress should reject.

Tax Increase, Not Loophole Closing. Reid's small business tax increase would consist of applying the 15.3 percent payroll tax on certain income earned by small businesses organized as S-corporations. The income newly subjected to the payroll tax under Reid's plan would be business income distributed to shareholders who also work for the business.[3]

Reid is selling his tax increase as "loophole closing" because, he claims, shareholders that are also employees of these small businesses are not paying the appropriate amount of payroll tax.[4] He misguidedly thinks that they are taking too much compensation in the form of business income through shareholder distributions and not enough as wages and salary income as payment for their labor. Wage and salary income is subject to payroll tax; the business income is not.

This raises two important issues. First, whether or not it is closing a loophole in the tax code, it remains a tax increase. The tax code certainly contains plenty of loopholes that are worthy of repeal, but each and every one becomes a tax hike if not balanced with a tax reduction of equal size elsewhere. If Reid believes that the budgetary effects of extending the student loan subsidy need to be offset, then he should be able to find some of the $3.6 trillion of federal spending suitable to cut.

The second issue is that there are already rules in place to ensure that hybrid shareholder-employees of S-corps properly allocate their compensation between the wages and salary they should earn as compensation for their labor (and thus pay the appropriate amount of payroll tax on that income) and the business income they are due as owners of the business.

If Reid believes these rules need tightening, then this is where he should focus his legislative efforts. Instead, his policy gives up any attempt at a facts-based identification of income, opting to force the payroll tax onto all income earned by shareholder-employees without any recognition that a portion of that income is legitimate business income that should not be subject to payroll taxes. This leads to the unmistakable conclusion that Reid's policy is not loophole closing but a brazen attempt to expand the payroll tax to small business income.

Continuing Down the Slippery Slope. The Reid proposal is of a kind with recent proposals seeking to recast the payroll tax. For example, while the payroll tax traditionally applied only to wage and salary income, Obamacare broke this previously long-held tradition.

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Obamacare applied a new 3.8 percent Medicare Hospital Insurance payroll tax add-on to investment income, including capital gains, dividends, rents, and royalties. It then used that income to fund new spending in Obamacare. This broke another precedent in that the Medicare payroll tax is now used to fund spending outside Medicare.

Reid's extension of the payroll tax would further erode both of these precedents by applying the payroll to business income for the first time and using the revenue raised to offset the cost of extending the subsidy for Stafford student loans. It would represent another big step down the slippery slope in which Congress increases the payroll tax as a way to pay for new spending every time it wants to expand the size of government.

Expands Double Taxation. An enduring flaw in the federal income tax is the double taxation of income earned by traditional chapter C-corporations. A major and long-standing goal of fundamental tax reform is to eliminate double taxation. Reid's proposal goes in the opposite direction and in the process would eliminate one of the reasons a small business incorporates as an S-corp: to avoid the double taxation of its income.

Traditional corporations, so-called C-corporations, first must pay the highest-in-the-world U.S. corporate income tax rate before they can distribute their earnings to their owners (shareholders) either as dividends or as capital gains if the income is retained. The shareholders then must pay the 15 percent (for now[5]) dividends or capital gains tax rate. Combining the corporate rate and the shareholder rate, the total effective tax rate on the income of C-corporations is therefore almost 45 percent.

S-corps are pass-through entities that do not pay tax at the business level. Their income passes through the business and on to their shareholders, who pay tax on their share of the business's earnings on their individual income tax returns. As such, their income is subject to tax only once.

In practice, Reid's plan would double tax the income of S-corps because shareholders would pay their share of the business's income tax *and* the payroll tax on top of that. The payroll tax would function much like the tax on dividends does on the income of C-corporations.

If this faulty policy became law, then most S-corps that would fall under the new double tax would change their form of business to one of the other pass-through options that are not yet subject to double taxation, such as sole proprietorships, LLCs, or partnerships. As a result, revenues over the first 10 years of the policy would likely come in far below the $9 billion estimate, and little to no revenue would come in after that time as businesses have more time to make the switch.

This ability of targeted S-corps to reorganize and thereby avoid much or all of the tax does not render the policy benign, however. S-corps have chosen their form of business organization because it is the most efficient available. Though they can avoid Reid's tax, they cannot avoid the loss of economic efficiency, jobs, and competitiveness that would follow.

Further, the ability of current S-corps to change their incorporation status to escape double taxation assumes that other business forms continue to avoid the double-taxed fate of C-corporations. Instead, subjecting S-corp income to double taxation could be the first step toward subjecting all business income to double taxation. Such a move would be consistent with President Obama's ongoing campaign to raise taxes on small business.

Yet Another Tax Increase on Small Business. In addition to this S-corp tax increase, there is President Obama's long-held plan to allow the Bush tax cuts to expire for incomes over $200,000, which would fall heavily on small business income. Reid has repeatedly tried, and failed, to pass a surtax of varying rates on

1. See Lindsey Burke, "College (Loan) Football: The Looming Interest Rate Hike," The Heritage Foundation, The Foundry, April 24, 2012, http://blog.heritage.org/2012/04/24/college-loan-football-the-looming-interest-rate-hike/.
2. Congressional Budget Office, "Estimate of Budgetary Effects of S. 2343, the Stop the Student Loan Interest Rate Hike Act of 2012," April 25, 2012, http://www.cbo.gov/sites/default/files/cbofiles/attachments/s2343.pdf (accessed May 7, 2012).
3. The newly taxed small business income would come from businesses in which 75 percent of the business's income is attributable to three or fewer shareholders. The payroll tax would apply to those owner-shareholders with modified adjusted gross income in excess of $200,000 a year ($250,000 for joint filers).
4. Pete Kasperowicz, "Sen. Reid Proposes Changing Tax Law to Pay for Lower Rate on Student Loans," *The Hill*, April 25, 2012, http://thehill.com/blogs/floor-action/senate/223613-reid-proposes-student-loan-bill-with-s-corp-tax-offset (accessed May 7, 2012).
5. See Curtis S. Dubay, "Taxmageddon: Massive Tax Increase Coming in 2013," Heritage Foundation *Issue Brief* No. 3558, April 4, 2012, http://www.heritage.org/research/reports/2012/04/taxmageddon-massive-tax-increase-coming-in-2013.

high incomes that would also fall heavily on small business. And, of course, small businesses would pay a large portion of President Obama's infamous Buffett Rule tax.

A clear and disturbing trend is emerging regarding the tax philosophies of both President Obama and Reid: They want badly to raise taxes on small businesses and will keep trying different ways to raise those taxes until finally successful.

As it has done with each of the previous attempts to punish small businesses with painful tax hikes, Congress should reject Reid's newest small business tax hike. It should instead focus on preventing Taxmageddon, the massive tax increase that will hit the economy on January 1, 2013.[6]

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6. Ibid.