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New Surtax and Expiring Tax Cuts Could Hit Business Income Simultaneously

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Business income may be in for a significant tax hike in 2011. The Ways and Means Committee has approved a new [5.4 percent surtax on income over \\$1 million and two smaller surtaxes on other high-income people](#). These may become law at the same time as the current top tax rate on wages (35%) reverts to 39.6% (end of 2010).

In most nations corporations dominate the business sector, and so these higher wage taxes would not have a dramatic effect on "business income." But the U.S. business sector includes millions of so-called non-corporate businesses organized as limited liability partnerships (LLPs), limited liability corporations (LLCs), S-corporations, and other forms. These American businesses pay their taxes on the individual tax returns of the owners. One argument, then, against raising personal income tax rates is that businesses will suffer.

The IRS is careful not to publish so much detail about the nation's individual tax returns that personal privacy could be breached, and this is especially true of high-income tax returns. Therefore, it is impossible to determine precisely whether a tax return with "business income" is actually a struggling or emerging business. However, to the extent we can analyze personal income tax returns to clarify the danger of high rates to "business income," we do so here.

Many seemingly contradictory statistics are cited on this issue, depending on the author's opinion of higher tax rates. If an author favors higher tax rates, he is likely to cite a statistic similar to this: only 4.8% of all tax returns with business income will face a tax increase. That's true because so many mom-and-pop businesses do not earn enough to pay the coming tax rates on high income.

If worried about the economic damage of higher tax rates (which we are), an author will cite this statistic: 62.6% of all business income is earned by tax returns facing a tax increase. That's true because those 4.8% of businesses that make enough to pay the new tax rates are large and profitable, and taxes on them hit much more income, potentially hurting many more workers.

Figure 1

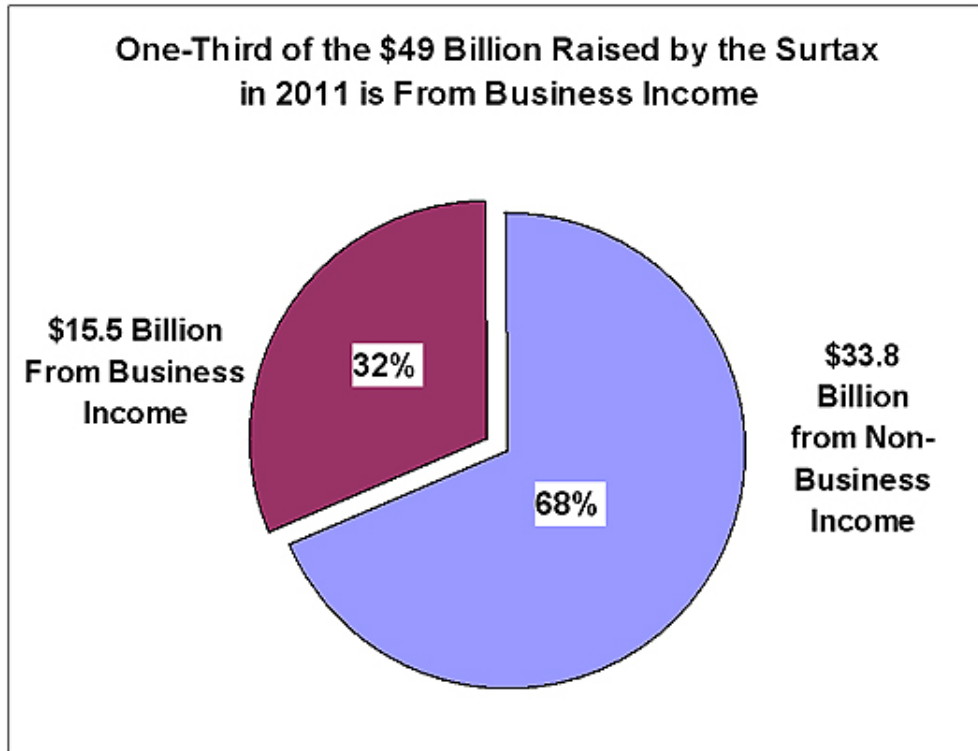


Figure 2

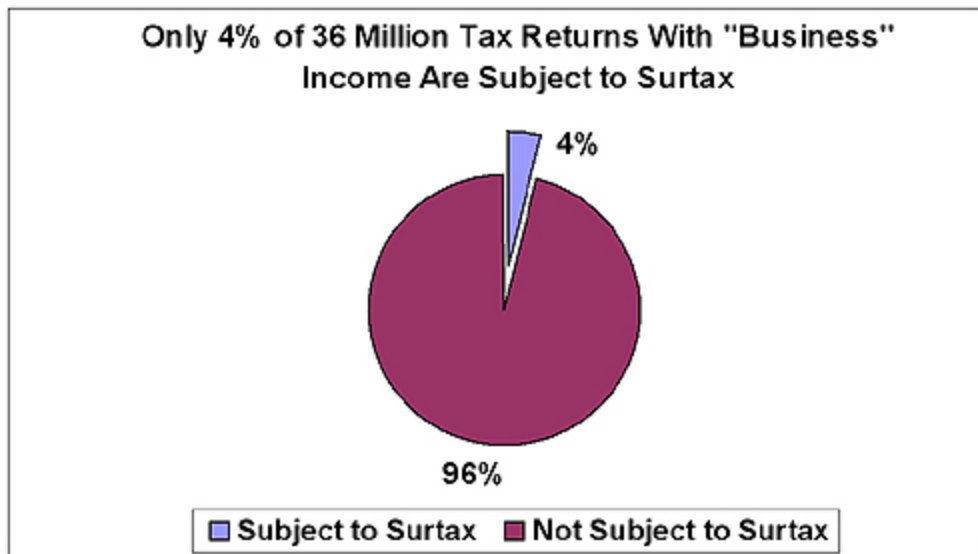
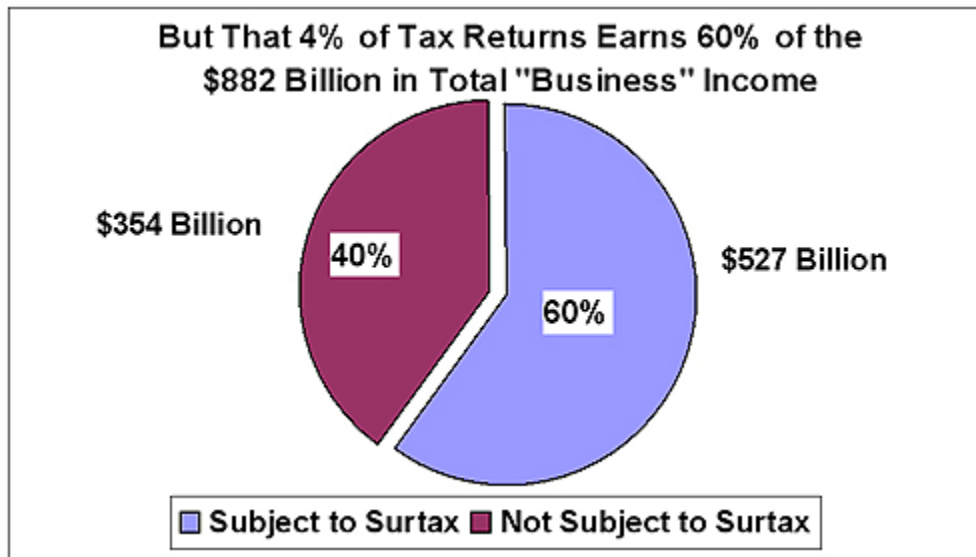


Figure 3



Here are some other statistics on business income. In each case, we are measuring the combined effect of a new surtax and the reversion of the top two tax rates to 36% and 39.6%.

- 70.1% of returns facing a tax increase have some form of business income.
- 26.0% of all income earned by those returns facing a tax increase is business income.
- 32.5% of all income earned by business returns facing a tax increase is business income.
- The total tax increase on business income would be \$51.3 billion, a 24.5% increase, assuming business income is the last dollar of income earned.
- 36.7% of the total tax increase is attributable to tax increases on business income, assuming business income is the last dollar of income earned.
- The average return with business income would face a total tax increase of \$3,246.
- The average return facing a tax increase would face a total tax increase of \$54,716.
- The average return with business income that is facing a tax increase would face a total tax increase of \$66,979.
- The average return with business income would face a tax increase on business income of \$1,388.
- The average return facing a tax increase would see a tax increase on business income of \$20,752.
- The average return with business income that is facing a tax increase would see a tax increase on business income of \$29,595.
- The total average tax rate on business income would increase from 23.7% to 29.5%, assuming business income is the last dollar of income earned.

Table 1
The Average Impact of Proposed Tax Increases (Health Surtax plus Expiring Bush Tax Cuts) on the Business Income of High-Income Tax Returns
Estimates for Tax Year 2011

Statistical Category	Returns with Business Income		All Returns	
	Business Returns with Tax Increase	All Business Returns	Returns with Tax Increase	All Returns
Number of Returns	1,789,459	36,921,366	2,551,973	141,226,026
Average AGI	\$948,414	\$107,340	\$832,104	\$64,469
Average Business Income	\$308,368	\$23,893	\$216,229	\$6,246
Average Total Tax (Baseline)	\$226,395	\$16,601	\$198,035	\$7,468
Average Total Tax (Policy)	\$293,373	\$19,847	\$252,752	\$8,457
Average Tax on Business Income (Baseline)	\$92,185	\$5,667	\$64,641	\$1,481
Average Tax on Business Income (Policy)	\$121,781	\$7,055	\$85,393	\$1,844

Note: Business income is defined as Schedule C income plus Schedule F income plus Schedule E income less income from royalties, trusts and estates. Any tax return with schedule C \sim 0, schedule E income less royalties, trusts and estates \sim 0 or schedule F income \sim 0 is defined as having business income. To calculate average tax on business income, we assume that all business income is the last dollar of income earned on a tax return.