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Small Business Tax Rates and Tax Complexity

Small businesses are sensitive to tax laws in ways big businesses are not. Most small businesses are pass-through entities that pay taxes at individual rates. Their financing differs sharply from corporate finance. Few have in-house accountants or human resources specialists to manage the paper flows.

A small business is not separable from its owner.

Small Businesses Are Personal. 75% of small businesses are unincorporated pass-through entities, so owners report business income on their personal taxes. This is true regardless of whether the owner is taking the profits home or plowing them back into the business.

Small business owners are close to employees.

Big businesses can respond to tax laws with layoffs, downsizing, outsourcing, shifting from full-timers to part-timers, etc. Small businesses lack this structural flexibility, in part because of owners' close personal ties to employees.

Few small businesses have administrative specialists or expertise.

Few small businesses have accounting or human resources specialists to handle taxes. Administrative tasks fall to owners, diverting them from their core businesses. Lacking tax expertise, 89% of owners rely on outside tax preparers.

Tax compliance is costlier for small businesses.

Tax compliance costs are 67% higher for small businesses than for big businesses. Compliance costs small-business owners \$18-\$19 billion per year. Paperwork costs come to \$74.24 per hour.

Individual tax rates directly affect business investment.

High Tax Rates Hurt. Pass-through businesses are unaffected by corporate tax rates but highly sensitive to individual rates. For example, one study showed that a 5% increase in the individual tax rate reduced by 10% the number of owners making capital investments.

Taxes interfere with small-business cash flow.

Small businesses rely on cash flow to pay day-to-day expenses like wages, benefits, and utilities. 50% of small businesses regularly face cash-flow problems; for 20%, the problem is continuous. Federal, state, and local tax payments compound the cash-flow problem.

Payroll taxes are especially onerous.

Payroll taxes increase the cost of labor, striking especially hard at labor-intensive businesses with thin profit margins. Payroll taxes must be paid (usually monthly) even when the business is going through period of stress and unprofitability. This eats into cash flow and increases financing costs.

Estate taxes discourage family businesses.

Estate taxes make it difficult for relatives to retain ownership of a family business when the owner dies or retires. Family assets often consist primarily of the land, building, and equipment of the business. So paying the estate tax means selling off parts of the business. Preparing for the estate tax requires time and money that could otherwise be used for investment and job creation.

Taxation of home offices is needlessly complex.

Complexity Also Hurts. Nearly 50% of small businesses are home-based, so home office deductions are important. Businesses were long discouraged from claiming this deduction because the rules were complex, with erratic enforcement and costly recordkeeping. The traditional deduction is still available, but there's now a second option – a simple \$1,500 standard deduction.

Cash accounting reduces complexity but is limited.

Businesses making less than \$5 million may use cash accounting rather than the more complicated accrual method. The cash method more accurately reflects small business expenses and reduces record-keeping and paperwork costs. Raising the threshold to \$10 million or more would help many small businesses.

Section 179 expensing encourages growth and reduces complexity.

Section 179 expensing allows a small business to immediately deduct the cost of investing in their business. This puts money back into the small business for investment rather than spreading the deductions out over a long depreciation schedule. Expensing also reduces tax complexity by eliminating the paperwork and record-keeping burden associated with longer depreciation periods.

These taxes affect a tremendous swath of the American workforce.

Magnitudes Matter. Pass-throughs employ 54% of the private sector workforce. Up to 25% of the workforce is employed by the nearly one million businesses that earn more than \$250,000. Thus, taxes aimed at those in high income brackets directly impact tens of millions of Americans.

Problems increase with complexity and tax rates.

All of the problems described above become worse as the tax code becomes more complex and as tax rates go higher. A simpler tax code and lower rates encourage small businesses to expand, to invest, and to create jobs.

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