



Cantor's "Small Business" Bill is a \$46 Billion Loophole for the Rich

Nine Reasons to Reject H.R. 9

By Seth Hanlon

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Introduction

The U.S. House of Representatives early next week will hold a vote on H.R. 9, a bill introduced by Majority Leader Eric Cantor (R-VA) to provide a one-year, 20 percent tax deduction for business income. The Cantor bill is sadly just another tax windfall for the rich, financed by larger federal budget deficits, which largely misses its ostensible target of small businesses and wouldn't create jobs.

As an economic strategy it's one we've tried before and a failure we don't want to repeat. Here are nine reasons why the House should reject H.R. 9:

1. H.R. 9 is a giant windfall for the very wealthy, not an incentive for small-business job creation
2. Half of H.R. 9's tax cuts go to millionaires, not to business owners who would most benefit from a tax break
3. H.R. 9 would benefit companies that eliminate or offshore jobs
4. H.R. 9's temporary tax break on business profits is a windfall, not an incentive
5. H.R. 9 arbitrarily favors some businesses over others
6. H.R. 9 encourages businesses to wait until next year to make investments
7. H.R. 9 misdiagnoses the fundamental problem facing small businesses and the broader economy—a lack of demand
8. H.R. 9 is the opposite of tax reform
9. H.R. 9 is paid for by \$46 billion in borrowed money

So let's look at each of these reasons to reject the bill in turn.

HR 9 is a giant windfall for the very wealthy, not an incentive for small business job creation

Under Rep. Cantor's bill, in general, all businesses with fewer than 500 employees are eligible for the tax deduction on their active domestic income. The term "small business" evokes images of mom-and-pop stores or startups hoping to expand, but in fact a very wide range of enterprises owned by extremely wealthy people have fewer than 500 employees. These businesses and their owners would reap a giant windfall from the Cantor bill.

An exchange during the House committee's consideration of the bill between Rep. Xavier Becerra (D-CA) and Thomas Barthold, who heads Congress's nonpartisan Joint Committee on Taxation, underscored that Rep. Cantor's tax cut could potentially provide large windfalls to the owners of a host of enterprises that are a far cry from the image Cantor tries to evoke of the struggling small-business owner. These include:

- Professional sports franchises, such as the Los Angeles Dodgers, which were recently sold for \$2 billion
- Donald Trump's Trump Tower Sales & Leasing
- Paris Hilton Entertainment, Inc.¹

In addition to the owners of enterprises like these, the Cantor bill would provide a sizeable tax cut to many highly paid professionals, including lawyers, lobbyists, doctors, stockbrokers, hedge fund managers, and other financial industry professionals. These well-compensated professionals are among the least in need of a tax cut—and also unlikely to use the extra cash from a tax cut to expand operations or hire others.² As one economist asked when discussing the Bush tax cuts, "Should we give the hedge fund managers millions of dollars of tax relief on the possibility that they might hire another office assistant?"³ The same question should be asked of Cantor's bill.

Half of H.R. 9's tax cuts go to millionaires, not to business owners who would most benefit from a tax break

An analysis by the nonpartisan Tax Policy Center shows that the Cantor bill is extremely skewed toward the wealthy. People with annual incomes above \$1 million would receive nearly half of the benefit from Cantor's bill, even though they comprise less than one half of 1 percent of all taxpayers.⁴ They also comprise a small percentage—just 4 percent—of small-business employers, according to a recent Treasury Department analysis.⁵

In fact, 76 percent of small-business employers have incomes below \$200,000. But that group receives only 16 percent of the benefit from Cantor's bill. And 55 percent of small-business employers have incomes below \$100,000, but that group receives only 6 percent of the benefit from Cantor's bill.

The tax benefits are badly skewed largely because of the bill's flawed design. A tax deduction tied to business income provides the biggest benefit to businesses that are already earning the largest profits and to business owners in the top tax brackets.

H.R. 9 benefits companies that eliminate or offshore jobs because there is no requirement that a company actually create jobs to claim the special deduction

If the purpose is to target tax relief to actual small businesses creating jobs then the tax break should at least be connected in some way to increased hiring—but the Cantor bill is not. Instead, the proposed legislation chooses perhaps the most costly and least targeted approach possible.

Under the Cantor bill there is no requirement that a business owner use the extra cash from the tax cut to reinvest in his or her business, as opposed to spending it on personal consumption or simply putting it in the bank. Businesses that do not create jobs—and even those that lay off employees—are still eligible for the deduction, as another exchange between Rep. Becerra and the Joint Tax Committee's Barthold made clear:

Rep. Becerra: Is there a requirement that you create jobs?

Barthold: There's no requirement on the result of the tax relief.

Rep. Becerra: So you don't have to create a job to get the 20 percent tax cut?

Barthold: That is correct, sir.

Rep. Becerra: What if you fired an employee? Can you still get a tax cut?

Barthold: The simple answer is yes.

Rep. Becerra: What if a company fires an employee in the United States and lays off an American worker and then hires people abroad by outsourcing that job, could that company still qualify for that tax cut?

Barthold: They could still qualify . . .

An amendment by Rep. Joseph Crowley (D-NY) in the House Ways and Means Committee to deny the deduction to businesses that have offshored jobs (expanding payroll abroad while cutting it in the United States) was rejected in a party-line vote.⁶

H.R. 9's temporary tax break on business profits is a windfall, not an incentive

For most business owners H.R. 9 would be a pure windfall with no effect on investment or job creation. Business owners make investments and hire people not because they have extra cash lying around but because those investments and hires will increase revenues by more than their cost. And because labor costs are deductible, a reduction

in tax rates on business profits, which is essentially what H.R. 9 offers, does not change marginal incentives for hiring. The point was summarized succinctly by economist Len Burman (referring to marginal tax rates on business owners in general):

Employers will hire a new worker if they expect the value of the worker's output to exceed what he or she is paid. If the hire is profitable before tax, it doesn't matter whether the employer gets to keep 60 or 65 percent of that additional profit. The new worker will also be profitable after tax. And if the worker cannot produce enough to justify his or her costs, income tax rate cuts cannot make the new hire profitable.

An unexpected, temporary windfall does little or nothing to change these fundamental dynamics and would therefore fail to boost the economy.⁷ A temporary deduction enacted several months into the year, which expires at the end of the year, is even less likely to change businesses' hiring and investment decisions. In its analysis of the bill, CBO concluded: "[T]he one-year of tax savings provided by the bill is unlikely to make the costs of much investment in physical capital or labor recruitment and training worthwhile."⁸

There are better ways to target tax incentives toward small business hiring. A Senate bill introduced by Majority Leader Harry Reid (D-NV), S. 2230, would provide a tax credit tied directly to increases in payroll from 2011 to 2012. The Congressional Budget Office has said that policies like these, which reduce the marginal cost to businesses of adding employees, provide the biggest "bang for the buck" in increased economic output and employment relative to their fiscal cost.⁹ Unlike Rep. Cantor's bill, the Senate bill's tax benefits would be limited to those companies that actually expand payroll.

H.R. 9 arbitrarily favors some businesses over others

The Cantor bill claims to be neutral toward businesses, giving all the same tax benefit. But a closer look at the bill reveals that it hardly creates a level playing field, instead it picks winners according to arbitrary criteria. Consider the following distortions and curious results of the Cantor bill:

- Business A and Business B both began 2010 with 500 employees. Over the course of that year Business A hired 100 people while Business B laid off 100 people. Under Rep. Cantor's bill, Business B would qualify for the deduction because it had 400 employees in 2011. Business A, with its 600 employees, would be above the cap.
- Businesses C and D are identical in all respects except that Business C has 490 employees, while Business D has 510. Business C gets the entire benefit of the Cantor bill, while Business D gets nothing at all, not even a partial deduction.

- Business E and Business F have the same level of profits from operations in 2012. But Business E has been doing well for several years, while Business F struggled through the recession, generating tax losses. Those losses can carry forward to 2012, which means that Business F will have no taxable income in 2012 even though it actually turned a profit. That means Business F gets no benefit from H.R. 9.
- Business G is a long-established business with relatively stable profits from major investments made years ago. Business H is a recent startup that does not expect to start generating profits for at least another year. Under Rep. Cantor's bill, Business G would get a large windfall, while Business H, the startup, would derive zero benefit because it has no taxable income in 2012.

H.R. 9 encourages businesses to wait until next year to make investments

The unofficial motto of the Brooklyn Dodgers used to be “wait ‘til next year.” That’s also an apt description of the Cantor bill, which creates incentives for businesses to postpone investments until sometime in 2013. The 20 percent deduction applies only to 2012,¹⁰ which means that business owners have a strong incentive to maximize taxable income in 2012 while minimizing it in 2013. One way they can do this is by delaying investments until 2013, so that any resulting tax deductions lower the business’s taxable income next year rather than this year.

Even if the bill’s impact on the timing of actual business activities is minor, the bill could heighten incentives to shift the accounting for items of income and expenses from 2012 to 2013, or vice versa. Inconsistencies in tax rules from year to year invite gaming the system and waste resources as businesses plan for tax conditions rather than market conditions. Temporary provisions might be worthwhile if they pack economic punch, but the Cantor bill does not.

H.R. 9 misdiagnoses the fundamental problem facing small businesses and the broader economy—a lack of demand

The ostensible goal of Cantor’s bill is to “help put more Americans back to work right away.”¹¹ In other words, the legislation should provide what used to be called “stimulus.” In Rep. Cantor’s words, “what the bill will do is it—bottom line—will put more revenues, more money into the hands of small-business owners so that they can reinvest those funds to retain and create more jobs and to grow their business.”

But economists agree that the economy is under capacity and that the major challenge today is a lack of demand. Small-business owners also seem to agree, identifying “poor sales,” or the lack of demand for their products and services, as their top concern in a prominent survey every month since June 2008.¹²

But the Cantor bill focuses tax cuts on wealthy people, who are the least likely to spend it. As CBO explains: “The impact of [a tax cut on business income] would come primarily through its effect on the income and wealth of business owners and stockholders, who generally have higher-than-average income and would therefore tend to spend a fairly small share of temporary additions to their income and wealth.”¹³

Rep. Cantor and other House Republican proponents of H.R. 9 maintain that allowing business owners to retain more of their earnings could have the effect of lowering their cost of capital. But, as CBO has explained, “A reduction in the cost of capital is likely to have less effect on a business’s decision to buy new machinery if demand for the business’s output is so low that the machinery would get little use.”

The chief economist of the National Federation of Independent Businesses similarly emphasized this point: “If you give a small business guy \$20,000 he’ll say, ‘I could buy a new delivery truck but I have nobody to deliver to.’”

In fact, there are significant supply-side tax cuts already in effect, including “bonus depreciation,” enhanced “expensing” for small businesses, and, of course, Bush-era tax rates. Yet a fundamental lack of demand continues to hold back the economy. These reasons help explain why CBO ranked tax cuts on business income among the least effective policies to grow the economy in 2012 and 2013.¹⁴

H.R. 9 is the opposite of tax reform

First, some pertinent recent background. On March 29, the House of Representatives approved a budget, authored by Rep. Paul Ryan (R-WI), bemoaning the “labyrinth of deductions” that the tax code has become and promising fundamental tax reform. Yet the Ryan budget failed to identify even a single tax deduction or tax loophole to be eliminated—even as it relied on the assumption that Congress will find a whopping \$4.6 trillion in budget savings by reducing unidentified “special deductions and carve-outs.” Rep. Ryan claimed that his budget is revenue-neutral, and \$4.6 trillion is the amount needed to pay for its proposed tax cuts in tax rates, which would primarily benefit corporations and wealthy individuals.¹⁵ By refusing to say what special tax breaks would have to be sacrificed, the proponents of the House budget raised doubts about whether they are actually serious about tax reform.

Now, fewer than three weeks later, the House Republican leadership brings forward a bill carving out yet another special loophole. To implement the temporary 20 percent deduction, the bill adds a new section to the Internal Revenue Code (section 200) and also mandates new Treasury regulations. It would require a complicated new tax form (Form 8903-A) and additional regulatory guidance, worsen compliance and record-keeping burdens on small businesses, and lead to more disputes between small businesses and the Internal Revenue Service, according to the IRS and Joint Tax Committee.¹⁶

The bill adds to the list of “tax expenditures,” which now numbers in the hundreds. And, as we have seen, it confers tax benefits unfairly, giving the biggest tax cuts to the rich and arbitrarily favoring some taxpayers over others with little or no justification.

In short, by creating more unfairness and complexity, H.R. 9 exemplifies all that is wrong with the existing tax code. It is the opposite of tax reform.

H.R. 9 is paid for by \$46 billion in borrowed money

Despite being a one-time, temporary giveaway, Rep. Cantor’s bill would inflate budget deficits by \$46 billion. There are no offsets, meaning that it is entirely deficit-financed. That approach contrasts with proposals like those in President Obama’s American Jobs Act, which were not only more powerful measures to create jobs but were also fully paid for.

In sum, H.R. 9 is an ineffective giveaway to the rich, poorly targeted toward small businesses, and even more poorly targeted toward job creation. It would create a new special loophole that would further complicate the tax code and arbitrarily select winners and losers. And it would worsen deficits with little or no job creation to show for it. The House should reject this approach in favor of more powerful measures to create jobs.

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Endnotes

- 1 As Barthold noted, the bill contains aggregation rules that apply the 500-employee limit to all entities under common control, so it is not possible to determine whether a specific business would benefit without knowing the owners' other holdings.
- 2 A study by University of Chicago researchers found that small businesses (classified by number of employees) primarily include those based on the owners' professional skills, such as lawyers, accountants, architects, doctors, and dentists as well as several other types of businesses that are unlikely to innovate or grow (or even want to grow). This suggests that tax cuts on business income, limited only by a firm's number of employees, would be a particularly inefficient subsidy for small business growth and job creation. See Erik Hurst and Benjamin Wild Pugsley, "What Do Small Businesses Do?" (Washington: Brookings Institution, 2011), available at http://www.brookings.edu/~media/Files/Programs/ES/BPEA/2011_fall_bpea_papers/2011_fall_bpea_conference_hurst.pdf.
- 3 Martin A. Sullivan, "Should We Raise Tax Rates on Wealthy Employers?" Tax Notes, Sept. 6, 2011.
- 4 Tax Policy Center, "T12-0084 - H.R. 9: The Small Business Tax Cut Act" (2012), available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3342&topic2ID=40&topic3ID=&DocTypeID=1>.
- 5 See Matthew Knittel and others, "Methodology to Identify Small Businesses and Their Owners" (Washington: U.S. Treasury Office of Tax Analysis, 2011), tbl. 15; Sarah Ayres, "Small-Business Owners Are Not Millionaires, and Millionaires Are Not Small-Business Owners" (Washington: Center for American Progress, 2011), available at http://www.americanprogress.org/issues/2011/10/small_business.html. The study identified small-business employers by excluding entities with minimal deductions for labor costs and other entities with "de minimus" levels of business activity. The Treasury study and Tax Policy Center estimates differ somewhat in how they classify taxpayers with \$1 million or more in annual income: The Treasury study is based on adjusted gross income, whereas the Tax Policy Center uses a concept of "cash income" that is broader.
- 6 House Ways and Means Committee, "Small Business Tax Cut Act" (2012), p.18, available at <http://www.gpo.gov/fdsys/pkg/CRPT-112hrpt425/pdf/CRPT-112hrpt425.pdf>.
- 7 As CBO has explained: "Policies that would primarily affect businesses' cash flow but would have little impact on their marginal incentives to hire or invest would have only small effects" on economic growth and employment in the near-term. Testimony of Douglas Elmendorf, "Policies for Increasing Economic Growth and Employment in 2012 and 2013," Senate Budget Committee, November 15, 2011. H.R. 9 limits the deduction to half of the amount a business pays in wages, with some wages not counted. This limit would create some marginal incentive to expand payroll in 2012 for the businesses that are close to or above this limit, but not those under the limit.
- 8 House Ways and Means Committee, "Small Business Tax Cut," p. 20.
- 9 Elmendorf, "Policies for Increasing Economic Growth and Employment in 2012 and 2013."
- 10 Technically it applies to the taxpayer's first tax year beginning after December 31, 2011, and a business taxpayer might have a tax year that starts later than January 1, 2012.
- 11 House Ways and Means Committee, "Small Business Tax Cut," p. 5.
- 12 See Adam Hersh and Heather Boushey, "Economy Fights Headwinds, Politics for Jobs Gain" (Washington: Center for American Progress, 2012). This report refers to the National Federation of Independent Businesses' monthly survey.
- 13 Elmendorf, "Policies for Increasing Economic Growth and Employment in 2012 and 2013."
- 14 See Chuck Marr, "Cantor Proposal for 20 Percent Business Tax Deduction Would Provide Windfall for Wealthy, Not Create Jobs" (Washington: Center on Budget and Policy Priorities, 2012), available at <http://www.cbpp.org/files/3-28-12tax.pdf>.
- 15 See Seth Hanlon, "Ryan's Secret Plan to Shift the Tax Burden Onto the Middle Class" (Washington: Center for American Progress, 2012), available at http://www.americanprogress.org/issues/2012/03/hanlon_ryan_column.html.
- 16 House Ways and Means Committee, "Small Business Tax Cut," p. 23.