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Not in Kansas Anymore: Income Taxes on Pass-Through Businesses Eliminated

By
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On May 22, Kansas Governor Sam Brownback (R) signed HB 2117 into law. This tax cut bill reduces income tax rates, increases the standard deduction, and eliminates some income tax credits. The legislation also exempts from tax some income of pass-through businesses. The tax reduction is estimated to be around $800 million annually beginning in 2014, totaling $4.5 billion over six years (see Table 1).[1] By comparison, the state's individual income tax brought in $2.7 billion in 2011.[2]

The legislation also allows a previously planned sales tax reduction from 6.3% to 5.7% to take effect as scheduled. The sales tax was previously increased from 5.3% to 6.3% in 2010.

The bill's evolution followed a strange path. The Senate, worried about the cost of the bill, had killed it in March. They then resurrected the measure hours later and passed it, in hopes of keeping the overall tax reform debate alive and negotiating a less costly tax cut package in a joint House-Senate conference committee.[3] House members perceived the subsequent negotiations as failing, and on May 9, passed the original, larger tax cut legislation, sending to the governor's desk a bill that the Senate had previously quashed.[4] Governor Brownback said that he would sign the bill, but also encouraged lawmakers to keep working toward a compromise if they were unsatisfied with the bill. Ultimately, no other compromise was reached, and the governor signed the bill into law.

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[1] For annual fiscal impact, see the legislative note for HB 2117, available at http://www.kslegislature.com/li/b2011_12/measures/documents/supp_note_hb2117_04_0000.pdf.
[2] U.S. Census Bureau, *State Government Tax Collections 2011*, http://www.census.gov/govs/statetax/.
[3] *See* Brad Cooper, *Brownback signs big tax cut in Kansas*, KANSAS CITY STAR, May 23, 2012, http://midwestdemocracy.com/articles/brownback-signs-big-tax-cut-in-kansas/.
[4] *See* Chris Courtwright, *Kansas Lawmakers Approve Income Tax Cuts*, TAX ANALYSTS: STATE TAX TODAY, May 11, 2012.

Table 1. Cost of Tax Cut Legislation, 2013-2018	
Fiscal Year	**Revenue Impact ($millions)**
2013	-231.2
2014	-802.8
2015	-824.3
2016	-854.2
2017	-892.9
2018	-933.7
6-yr Total	-4,539.1

Income Tax Rates Lowered, Base Broadened

Prior to the passage of the tax reform legislation, Kansas had three income tax rates: 3.5%, 6.25%, and 6.45%. Under the new law, the top rate and bracket are eliminated, the 6.25% rate is reduced to 4.9%, and the 3.5% rate is reduced to 3% (see Table 2). The standard deduction will increase, from $4,500 to $9,000 for a head-of-household filer and from $6,000 to $9,000 for a married couple. The law eliminates several individual income tax credits, such as a tax credit to offset sales tax paid on groceries, an adoption tax credit, an alternative fuel equipment tax credit, child care tax credits, and others.[5] In addition, renters will no longer qualify for a low-income property tax credit.

Table 2. Income Tax Rates Under Previous Law and HB 2117					
	Previous			**New**	
	On Income above			**On Income above**	
Rate	Single	Married	**Rate**	Single	Married
3.5%	$0	$0	**3%**	$0	$0
6.25%	$15,000	$30,000	**4.9%**	$15,000	$30,000
6.45%	$30,000	$60,000			

New Law Exempts Income from Partnerships, LLCs, S corporations, and Sole Proprietorships

In addition to the individual income tax changes, the new law changes the way pass-through businesses are taxed. These businesses (such as LLCs, S corps, partnerships, farms, and sole proprietorships) are generally taxed not under the corporate income tax, but rather on the income "passed through" to the tax return of the business owner. This income is thus taxed under the individual income tax.[6]

[5] For a full list of the repealed credits, see the legislative note.

[6] Pass-throughs are commonly referred to as "small businesses," but the legal distinctions between pass-throughs and corporations are more about business structure than size.

A business owner typically pays herself a salary, which is taxed as wage income on their income tax return. Additional profit above and beyond the business's cost of doing business (which includes cost of materials, wages, etc.) is reported as one of several forms of business income on the business owner's tax return (federal tax Schedules C, E, and F) and also taxed under the personal income tax. The new Kansas law would make this non-wage income exempt from taxation, a change the governor's office says will eliminate income tax on 191,000 businesses.

The tax exemption for pass-through businesses is a substantial change. Proponents of the change hope that it will spur economic growth and job creation by small businesses. The governor's office stated that "dynamic projections show the new law will result in 22,900 new jobs, give $2 billion more in disposable income to Kansans and increase population by 35,740, all in addition to the normal growth rate of the state."[7] However, some critics have responded that a new "small business" exemption is misguided policy.[8] Indeed, we see a few problems with the small business provisions.

Preferentially Taxing Pass-Through Entities Encourages Restructuring

First, the exemption creates an incentive for businesses to structure as pass-throughs for tax reasons, even if it might be unwise to do so for non-tax reasons. Instead of the Kansas tax system treating similar activity similarly, the system will encourage economically inefficient, though tax-reducing, activities. While this can be difficult and complicated, especially in business taxation, Kansas's decision to exempt one type of business structure completely from taxation (pass-throughs) while continuing to tax others (C corporations) is problematic. It rewards certain business structures while punishing others. There is no sound economic justification for treating these two types of business activity so dramatically differently.

Encouraging Pass-Through Entities Not Necessarily the Same as Encouraging Small Business

In addition, the focus on small business may be misguided. Small businesses are often touted as the primary job creators and engines of the economy, but the evidence supporting this conclusion is mixed. Many "small businesses," for example, are individuals who work a salaried job as their major source of income but earn a small amount doing work on the side (e.g., babysitting or freelance writing) and are unlikely to expand or hire additional workers. One key study found that there is no connection between firm size and growth. At the same time, the study found that younger firms, not smaller firms, do grow faster (though they are also more likely to fail), suggesting that firm age may be important for job creation.[9] However, policy makers should be careful to note that a young firm is not the same thing as a small firm, nor will a young firm necessarily be organized as a pass-through.

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[7] Governor Brownback's press release, *Governor Brownback signs pro-growth tax legislation*, May 22, 2012, https://governor.ks.gov/media-room/media-releases/2012/05/22/governor-brownback-signs-pro-growth-tax-legislation.

[8] *See, e.g.*, Center on Budget and Policy Priorities, *Proposed Kansas Tax Break for "Pass-Through" Profits Is Poorly Targeted and Will Not Create Jobs*, Mar. 26, 2012, http://www.cbpp.org/cms/?fa=view&id=3662.

[9] John C. Haltiwanger, Ron S. Jarmin, & Javier Miranda, *Who Creates Jobs? Small vs. Large vs. Young*, NBER Working Paper No. 16300, Aug. 2010, http://www.nber.org/papers/w16300.

After conducting a broad review of the existing research, the Federal Reserve Bank of Minneapolis concluded: "After three decades of investigation, the question of whether small firms do indeed create proportionally more jobs than large firms resists resolution."[10] Ultimately, large and small businesses are both important to the economy and states should resist favoring one at the expense of the other.

Further, a pass-through business is distinct from a small business. In fact, it is primarily large businesses that account for a large fraction of the assets, revenues, and profits of pass-through entities, as pointed out by Donald Marron of the Tax Policy Center. He notes that firms with over $50 million in revenues make up just 0.1% of all pass-through businesses but account for 40% of pass-through revenues. Firms with over $10 million in revenues account for 0.4% of pass-through businesses and 60% of pass-through revenues.[11] Tax policy that targets pass-through entities is thus not necessarily effective at targeting "small business."

While favoring the pass-through structure over C corporations may lead to an increase in people employed by pass-through entities, not all these jobs are new. As discussed above, the new tax-exempt status provides a large incentive for new and existing businesses to organize as pass-throughs rather than C corporations. "New" pass-through entity jobs may just be reclassified C corporation jobs.

Conclusion

Kansas is on the right track by broadening its tax base and lowering its rates, but should be cautious about favoring some businesses over others. A better path to encouraging economic growth is creating a tax environment that is not overly burdensome and treats all businesses well. Further, while tax reductions can have positive economic benefits, they will cost revenue and will ultimately have to be paid for either by cutting spending or increasing taxes elsewhere.

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[10] Federal Reserve Bank of Minneapolis, *Sizing up Job Creation*, Sept. 2010, http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4538.
[11] Donald B. Marron, testimony before the U.S. House Ways and Means, Subcommittee on Select Revenue Measures, *Tax Policy and Small Business*, Mar. 3, 2011, http://www.urban.org/uploadedpdf/901412-Tax-Policy-Small-Business.pdf.