Cutting Business Taxes Won't Help Maryland's Economy

Exempting a large category of business owners from paying income taxes on their profits is an ineffective strategy for growing a state's economy – and Maryland would do well to reject the idea.

Maryland should learn from the experiences of Ohio and Kansas, which have had to reduce essential state services after lowering or eliminating taxes for certain categories of businesses. Such actions won't drive job creation in Maryland and could actually set the state's economy back if we have to cut services that support a healthy, thriving economy, like schools, transportation and public safety.

Some Maryland leaders are exploring the idea of reducing the amount of taxes paid by certain types of businesses, often described as "pass-through-entities."

The term "pass-through entity" refers to several types of business structures that have one thing in common: how they pay their taxes. For tax purposes, the profits (or losses) from these businesses are passed through from the business to its partners, shareholders, members or beneficiaries—its owners. The owner or owners then report this income (or loss) on their personal income tax returns and pay taxes on it at the appropriate personal income tax rate, rather than the corporate rate.

Pass-through entities include[i]: partnerships, limited liability companies, business trusts, and S corporations. Sole proprietorships are often considered to be pass-throughs as well. Each type of business structure has its advantages, including things like the ease of setting up and operating the business or the ability to additional capital to grow the business. Business owners have the option to pick the legal structure that works best for their business and it can evolve over time as the business's needs change.

Over the past three decades, there has been a steady increase in the number of businesses choosing these structures and opting to file personal income taxes. In 1980, pass-through entities accounted for 20.7 percent of U.S. business profits. By 2011, this figure rose to over half (54.2 percent) of business profits, according to a recent study[ii] by academic and U.S. Treasury Department economists. More than 90 percent of businesses[iii] in the United States are structured as pass-through entities, according to the Tax Policy Center.

Maryland now receives more income tax payments from pass-through entities (about $1.1 billion in 2014) than from corporations, because of the large number of businesses structured this way. So it is clear that reducing the tax rate would take away much-needed resources from state services.

For one thing, pass-through entities generally don't make enough money for tax savings to be large. Nationwide, only 13 percent of small businesses[iv] have $50,000 or more in taxable income in a given year. The rest either make less than that or lose money. Maryland's tax rate at this income level is already such that the savings a typical business would receive from a tax cut would be a few hundred dollars, at most – not nearly enough to even pay one part-time worker's salary.

Further, most people who choose to structure their business this way do not have employees and are unlikely to ever hire any. Many, for example, are accountants, consultants, skilled trades persons, or others who contract directly with clients. Nationally, about 89 percent of people reporting income from pass-through entities have no employees.

Income from pass-through entities is especially concentrated among the wealthiest Americans, even though most startups and small businesses with limited income are set up as pass-throughs. The top 1 percent of households reporting income from pass-through entities account for more than two-thirds of pass-through profits. In other words, the vast majority of business owners are receiving little or no income from their businesses and would not benefit significantly from lowering tax rates on pass-through entities. Most of the tax savings would go to wealthy business owners.

Meanwhile, public investments in schools, transportation, and safe communities are at the heart of what makes Maryland a good place to live and do business. In order to maintain these investments, it is essential that everyone pays their fair share – and that includes the business community.

Endnotes

[i] Comptroller of Maryland. Income Tax Information for Pass-Through Entity Tax. http://taxes.marylandtaxes.com/Business_Taxes/Business_Tax_Types/Income_Tax/Tax_Information/Pass-Through_Entities/

[ii] Cooper, Michael, et al. National Bureau of Economic Research. Business in the United States: Who Owns it and How Much Tax Do They Pay. October 2015. http://conference.nber.org/confer/2015/TPE15/Cooper_McClelland_Pearce_Prisinzano_Sullivan_Yagan_Zwick_Zidar.pdf

[iii] Rosenberg, Joseph. Tax Policy Center. Flow-Through Business Income as a Share of AGI. September 2014. http://www.taxpolicycenter.org/UploadedPDF/1001750-flow-through-business-income.pdf

[iv] Mazerov, Michael. Center on Budget and Policy Priorities. Cutting State Personal Income Taxes Won't Help Small Businesses Create Jobs and May Harm State Economies. February 2013. http://www.cbpp.org/sites/default/files/atoms/files/2-19-13sfp.pdf