BTC Brief

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# North Carolina’s Business Tax Deduction:

## Who Benefits?

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### KEY FINDINGS

- **The $50,000 business income tax deduction created by the General Assembly in 2011 was intended to support small business and job creation, but it is unlikely to do so – at what may be an even higher cost to the state than was originally forecasted.**
- **Contrary to stated claims, this deduction is not targeted specifically to employers or small businesses, and while it is costly in terms of revenue lost, even at its maximum value of $3,875 it is unlikely to spur new hiring or enable significant capital investment.**
- **A recent Treasury study of the characteristics of businesses eligible for this deduction found that only 49 percent of non-passive, positive-income-reporting partners and S corporation shareholders were also employers. The same study also found that small businesses reported just 17 percent of total and net business income, and only 1 in 5 met the IRS definition of an employer.**
- **An independent micro-simulation model-based estimate of the cost of the deduction performed by the Institute for Taxation and Economic Policy (ITEP) that accounts for the interaction between tax schedules – unlike the official tabular data estimate – shows a possible high-end cost of the deduction of $552 million, which is $216 million more than was estimated in 2011.**
- **The deduction disproportionately benefits high-income businesses and individuals. The micro-simulation model showed that 70 percent of the tax cut goes to the top 20 percent of taxpayers with some net positive business income, with the remaining 30 percent of the tax cut spread out amongst 80 percent of taxpayers.**

### Introduction

In the 2011 budget, the North Carolina General Assembly created a deduction for the first $50,000 in non-passive income for businesses filing through the personal income tax. Proponents of the temporary tax break intended it to provide tax relief to small businesses and support job creation. However, in recent months there has been

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considerable debate over the business tax deduction and its ability to deliver on this promise, as well as its actual cost and its impact on businesses and the economy.

The Budget & Tax Center has taken a deeper look at the tax deduction in light of this debate and the upcoming discussion on modernizing the state's revenue system. The analysis finds this business tax deduction will not generate the promised job creation and fails to target small businesses struggling in today's economy—at a cost to the state that is likely higher than was originally estimated.

## North Carolina's Business Tax Deduction

The business tax deduction passed in 2011 allows a taxpayer reporting net business income on a personal income tax return to deduct up to $50,000 of net non-passive business income included in his adjusted gross income. A married couple filing jointly where both spouses have business income can deduct up to $100,000. There are no restrictions on this deduction, which if claimed in full has a value of $3,875.

The distinction between passive and non-passive income is key to understanding business income for the purposes of this deduction. The Internal Revenue Service defines passive income as a rental activity or business activity in which the taxpayer does not materially participate.[1] Per this definition, if an individual rents out a beach house that he owns independent of other business income he may earn, it qualifies as passive income.

However, if a property management company engaged in the full-time business of renting properties rents out a beach house, the net income from that activity would qualify as non-passive income. Non-passive income—the only kind of income against which a taxpayer can claim this tax deduction—includes self-employment income and earnings gained from active management of a business.[2] It is also worth noting that non-passive income includes income from working interests in oil and gas interests as well as income from partnerships or S corporations that trade in stocks, bonds, or securities for the accounts of the partners and/or shareholders.[3]

## Business Deduction Does Not Support Small Businesses or Encourage Job Creation

During consideration of the 2011-13 biennial budget in the 2011 legislative session, proponents of this business deduction claimed it would encourage job creation and support small businesses, particularly those that are employers. However, neither of these claims withstands closer examination.

The types of businesses that can benefit from the deduction will have completed one or more of the federal tax forms—Schedules C, E or F—necessary to report their business income or losses. Businesses that file these federal tax schedules vary greatly in structure, size, profitability, and employer status. The kinds of businesses that can claim the deduction are primarily sole proprietorships, partnerships or S corporations.

In August 2011, the Office of Tax Analysis within the U.S. Department of the Treasury released a rigorous study of the characteristics of the specific types of businesses that file through the personal income tax code.[4] The Treasury study found only 49 percent of non-passive, positive-income-reporting partners and S corporation shareholders—exactly the kind of taxpayers that would be able to claim the business deduction—were also employers.[5] Furthermore, the study found that while just more than half of the firms met the criteria for both a business and a small business,[6] those firms reported just 17 percent of total and net business income, and only 1 in 5 met the IRS definition of an employer.[7]

Given that the IRS definition of non-passive income is inclusive of several types of investment income and that the deduction is not in any way limited to employers, it is more than likely that numerous non-employer businesses will claim it without generating any significant economic return to the state. The full value of the credit—which only the highest-income businesses would be able to claim—is $3,875, which when taken at a statewide scale constitutes a significant loss of General Fund revenue, but on a firm-by-firm basis is far less than what would be needed to fund a full-time position for a year or make any kind of significant capital investment.

## Estimating the Fiscal Impact and Incidence

The original fiscal impact estimate of the business tax deduction uses tabular data from the Department of Revenue for the most recent tax year available, 2009, to calculate the cost of this tax policy. Because the availability of data coincided with the trough of the Great Recession, it is possible that the cost will be higher in a different tax year when businesses are more profitable and more likely to claim a greater deduction.

Subsequent analysis issued by the NC General Assembly's Fiscal Research Division on who benefits used the same data source to determine the benefits by taxable income brackets. This presents some challenges in getting an accurate estimate of the fiscal cost and incidence of this policy. Since tabular data cannot account for the interaction between different tax schedules, the resulting estimate is more susceptible to errors in assessing who actually benefits. And because the thresholds reflect taxable income, it does not present the total income of a taxpayer before deductions and exemptions. A taxpayer then could have $500,000 in income but only $50,000 in taxable income after accounting for all allowable business deductions, such as rent, taxes, or employees' pay.

The Institute on Taxation & Economic Policy's micro-simulation tax model is able to account for the interaction across tax schedules using actual tax return data.[8] While the model cannot parse out passive and non-passive income, it does provide greater accuracy based on the ability to model these interactions. In addition, because the model reports by income—and not taxable income—it provides information about who benefits by income group and assesses the value of the tax change using various measures.

## Benefits Accrue to Higher-Income North Carolinians

Analysis of the business income tax deduction using ITEP's micro-simulation model shows that the greatest share of the tax cut goes to the top 20 percent of taxpayers with some net positive business income; they receive 70 percent of the cut's value. The share of the tax

| 2012 Income Groups | Lowest 20% | Second 20% | Middle 20% | Fourth 20% | Next 15% | Next 4% | Top 1% |
|---|---|---|---|---|---|---|---|
| Income | Less than | $18,000 – | $31,000 – | $51,000 – | $82,000 – | $164,000 – | $379,000 – |
| Range | $18,000 | $31,000 | $51,000 | $82,000 | $164,000 | $379,000 | Or More |
| **Taxpayers with Business Income** | | | | | | | |
| Tax Change as % of Income | –0.7% | –0.5% | –0.6% | –0.9% | –0.9% | –0.9% | –0.3% |
| Average Tax Change | –$69 | –$124 | –$269 | –$599 | –$1,080 | –$2,285 | –$3,148 |
| % of Income Group Receiving Tax Cut | 38% | 52% | 76% | 93% | 95% | 99% | 100% |
| | | | | | | | |
| Avg. Tax Cut for Those Receiving Cut | –$180 | –$238 | –$356 | –$644 | –$1,139 | –$2,315 | –$3,162 |
| Share of Tax Change to Income Group (by total $) | 1% | 2% | 8% | 18% | 24% | 30% | 16% |
| Share of Tax Change to Income Group (by total returns) | 7% | 9% | 21% | 26% | 20% | 12% | 5% |

**SOURCE**: Special Data Request, Institute on Taxation and Economic Policy, October 2012
**NOTE**: Allowed exclusion to apply to all Schedule C, E and F income representing a higher-bound estimate than the analysis provided by the Fiscal Research Division in 2011.

cut going to the bottom 80 percent of taxpayers with some net positive business income is 30 percent. ITEP's replication of the Fiscal Research Division analysis finds a distribution of 59 percent of the value of the deduction going to the top 20 percent while the bottom 80 percent received 41 percent of the tax cut.

Under the more conservative scenario from the Fiscal Research Division, the average tax cut for the bottom 80 percent would be just $180, while for the top 20 percent the average tax cut would be almost $1500. The maximum tax cut for the deduction would be $3,875.

## Potential High Cost, Low Return

The actual bottom-line impact of this business tax deduction on state revenue collections will not be known until April 2013.[9] However, there is sufficient evidence to suggest that the cost of this policy may be more than the $336 million estimate. The upper-bound estimate of the potential cost provided through ITEP's micro-simulation model is $552 million. Again, ITEP's analysis does not use tabular data but instead simulates the interactions between tax schedules and income losses and gains, and it uses updated data from 2012.

An additional confounding factor to both estimates is that this tax policy has the potential of impacting taxpayer behavior. Specifically, by allowing for the deduction of business income, it is highly likely that entities will pass compensation on to individuals as pass-through income or undertake other forms of tax avoidance.[10] This is more likely to benefit higher-income taxpayers who work with tax attorneys to plan their tax returns.

The Fiscal Research Division's estimate of $336 million presents a redirection of funds away from important investments that yield measurable short- and long-term economic returns. These funds could serve 67,000 at-risk four-year olds with pre-kindergarten services, which have been demonstrated to yield significant economic returns through improved educational and employment outcomes over their lifetimes. These funds could also close the Medicaid shortfall, ensuring North Carolinians can access preventative, cost-effective health care and injecting dollars into the health care industry.[11] The decline in available revenue for public structures that generate economic growth will negatively impact the long-term prospects for opportunity.

## Conclusion

As North Carolina embarks on revenue modernization in 2013, it is critical that state policymakers review tax policies for their ability to achieve important public policy goals. The extension of the business tax deduction passed in 2011 only further contributes to North Carolina's upside-down tax system and erodes the availability of revenue for other critical public structures with greater potential to yield long-term job creation.

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1 See IRC § 469(c) and IRS Reg. § 1.469-2T(c).

2 See IRS Publication 925, available at: **http://www.irs.gov/publications/p925/ar02.html**

3 See IRS Reg. § 1.469-1T(e)(6).

4 Knittel, Matthew, Prisinzano, Richard, et al. Methodology to Identify Small Businesses and Their Owners. Office of Tax Analysis, Department of the Treasury, Technical Paper 4, August 2011.

5 See Table 13: Partners and S Corporation Shareholders and Income – Business, Small Business, Employer, Small Employer, by Active/Passive and Gain/Loss 1/ in the Treasury study referenced above.

6 For purposes of this study, the Office of Tax Analysis defined "small businesses" as meeting a threshold of $10 million in income or deductions.

7 Knittel, Matthew, Prisinzano, Richard, et al. Methodology to Identify Small Businesses and Their Owners. Office of Tax Analysis, Department of the Treasury, Technical Paper 4, August 2011.

8 ITEP Tax Model Methodology accessed at: **http://ctj.org/ITEP/about/itep_tax_model_full.php**

9 Tax return data claiming the deduction will not be available until sometime after the April 15, 2013 personal income tax filing deadline for tax year 2012.

10 Johnson, Nicholas, et al

11 Budget & Tax Center analysis of the Final FY 2011-2013 budget.

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