

Pass Small Business Tax Reform Now

By: *Alfredo Ortiz*

While tax reform languishes, all Americans pay. Washington needs to act quickly, but it also needs to get the policy right.

Reducing America's tax burden is the fastest way to boost real wages, which have been stagnant for decades. President Trump's tax plan would put hundreds of dollars a month back in the pockets of working and middle-class Americans, who are struggling under the weight of inflated housing, healthcare, and childcare costs. But if his comprehensive tax reform can't pass Congress, then Republicans should pass more tailored tax reform now that would still provide relief to tens of millions of Americans while being nearly impossible for legislators to oppose.

The specific reform with the most bang for the buck? Small business tax relief.

Small businesses, which generally structure as so-called pass-throughs that are taxed at the individual rate, pay a top marginal federal tax rate of 40 percent. Including state and other taxes, this rate often exceeds 50 percent. According to a recent Job Creators Network poll of small business owners, 70 percent of respondents said this over-taxation threatens their viability. And according to a new CNBC poll, taxes are the number one concern of small business owners.

The impact of this tax burden is demonstrated by the data. A recent JPMorgan Chase study shows that small business expansion is negligible. There has been a decades-long slowdown in new business

creation. And the share of businesses less than a year old has plummeted by one-third and their employment share by half since the 1980s.

Trump's tax plan would provide such relief by lowering the small business tax rate to 15 percent. Reps Randy Hultgren (R-IL) and Jason Smith (R-MO) have a similar plan that would drop the rate on the first \$150,000 in earnings to 12 percent and to 25 percent on all income above that threshold. Either reform passed as a standalone bill would strengthen the country's small business backbone by allowing more capital to expand, raise wages, and hire more employees.

While the politics of tax relief is easy – what Republican or Democrat in their right mind would oppose such a Main Street provision – the policy, as we saw in Kansas, can be tricky. What does small business tax relief look like? It starts with a specific rate for small business income, just as there is a specific rate for corporate income.

This raises the tough question of how to define small business income and how we should treat passive and active owners. Just like the dividend rate applies to all of the dividends that a shareholder receives from a large corporation, passive owners of a pass-through business should benefit from the small business rate. Similarly, an active owner should get the business rate on whatever portion of their income is related to the return on the capital they invested in the business. Whatever "labor"

the active owner puts in, should be taxed as such – as wage income.

But some in Washington haven't been willing to compromise on what constitutes wage versus capital income – meaning no one is getting the tax relief they deserve. However, there is a solution: agree to a simple mechanical rule that is easy for small business owners to understand and easy for the IRS to administer. Now, just as in life, every rule will have its exceptions and the IRS is well equipped to handle such exceptions. A fair formula would benefit the vast majority of America's small businesses – and prevent the US from repeating the mistake in Kansas, where there was no distinction made between business and wage income.

Lastly, the pursuit of utopia should not kill this once-in-a-generation opportunity to reform our tax laws. The headline tax rate for small businesses doesn't have to be the exact same as it is for corporations. While it would be nice, it's not necessary for successful reform. The reality is small businesses don't pay a second layer of taxes the way corporate profits are taxed when they are distributed as dividends.

If Washington and America's small businesses could rally around these common sense proposals, real economic activity would be unleashed across America's heartland.

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