Creating Winners & Losers: Lessons for Missouri on the Implications of the Business Income Deduction

On top of budget restrictions made earlier this year, state lawmakers putting together next year's state budget are considering additional cuts to a number of services that help Missouri families stay afloat, including cuts to school transportation and higher education and reducing the availability of home and community-based services and tax credits for seniors and people with disabilities. In the same budget year that these cuts would go into effect, a package of tax cuts is slated to be implemented.

Missouri lawmakers face an important window of opportunity to reevaluate one of these cuts, the "business income exemption," which has been significantly more expensive than anticipated in Kansas, wreaking havoc on its budget.

<u>In fact, the Missouri Budget Project estimates that the deduction will likely cost around $193 million annually.</u>

By repealing this provision before it goes into effect, lawmakers can stabilize state revenue, protect critical services for Missourians, and avoid a system of preferential treatment for select businesses that creates "winners and losers" in Missouri's economy.

The Business Income Deduction Creates Winners & Losers in Missouri's Economy

Senate Bill 509, passed by state lawmakers in 2014, reduces the top rate for individual income tax from 6 to 5.5 percent and creates a 25 percent exemption on business income tax for certain businesses.

These tax cuts have not yet been implemented due to a "trigger" provision that required state revenue to grow by at least $150 million compared to the previous year in order for the phase-in of the cuts to begin.

While the trigger was not reached in 2017, Missouri is expected to begin implementing the tax cuts in 2018, reducing revenue for the fiscal year 2018 budget.

The business income deduction in Senate Bill 509 effectively provides a tax cut for a select group of businesses, including LLCs (limited liability companies), S-corporations, Partnerships and Sole Proprietorships that file their taxes through the individual income tax structure. Taxes for those business owners would be reduced by 25 percent, while Missouri families and other Missouri companies would continue to pay state tax on the majority of their income. As a result, the new exemption creates an incentive for businesses to change their corporate structure in order to avoid paying state tax.

Tax analysts across the political spectrum agree that this provision simply encourages tax avoidance by giving certain businesses an unfair tax advantage, and it does nothing to stimulate economic growth. In fact, The Tax Foundation points out that this type of business income exemption unfairly rewards certain businesses simply for the way they are structured, and that *"There is no sound economic justification for treating two types of business activity so dramatically differently."*[1]

As the Center on Budget and Policy Priorities has pointed out, the tax exemption would do little to incentivize economic growth because, *"A substantial share of the profit exempted from tax…. is earned by wealthy owners of large investment funds and other business entities that have no employees."*[2] Further, many of the small businesses that would receive the tax cut under the new exemption are individual contractors or consultants who are also not likely to hire employees. In other words, the exemption will not lead to job growth. Businesses simply do not hire additional employees because they receive a tax cut, they hire when the demand for their services or products increase.

In fact, a similar provision was included in the Kansas tax cuts that passed in 2012. While the LLC exemption likely resulted in the growth of registered LLCs, it has not spurred economic or job growth there. In fact, "Kansas has consistently lagged the region and the nation in most measures of economic performance since the tax plan took effect, including personal income growth, gross domestic product, and job growth. In 2015, Kansas ranked 46th in the country in job growth."[3]

The Cost of the Business Income Deduction is Unpredictable

The real cost of SB 509 could be much higher than was anticipated when the legislature approved the bill in 2014. Business income has grown significantly and similar changes in Kansas have wreaked havoc on its budget. Moreover, Missouri recently saw that legislation that changed how corporate taxes were calculated for multistate companies cost much more than expected.[4]

The official fiscal note on Missouri's Senate Bill 509 estimated that the deduction for business income would account for $95.8 million of the bill's $620 million annual cost when fully implemented. However, that estimate was based on the amount of business income reported through the individual income tax in 2011.

Since that time, with the end of the recession, the amount of business income reported by LLCs and other pass-through entities in Missouri has increased 43 percent in just four years - from $9.8 billion in 2011 to $14 billion in 2014.[5]

The fiscal note did not account for this level of growth when estimating the cost of Senate Bill 509, so the official cost estimates are certain to be lower than the actual cost of the bill. Using the more updated data on reported business income, and projecting out over the phase-in period of the bill, **the Missouri Budget Project estimates that the cost of the deduction will likely be closer to $193 million annually.**

Furthermore, because the **design of the exemption creates an incentive for businesses to change their filing status,** the cost of the provision is unpredictable. If Missouri companies change their filing status in order to take advantage of the new exemption, the realized cost will likely be substantially higher than originally estimated.

Unpredictable Revenue & Other Lessons from Kansas

This uncertainty regarding the cost of these tax cuts is borne out by Kansas' experience. The original estimate of the annual cost of the Kansas tax cuts was $800 million per year when fully implemented. This estimate included all that state's tax cuts – not just the business income exemption.

Yet even after taking expected losses in state revenue into account, Kansas state revenue has continued to fall well below forecasts in each year since implementing the tax cuts. By 2016, state revenue was $465 million lower than expected.[6] In fact, since the implementation of their tax cuts, budgeting has become completely unpredictable in Kansas; the state has enacted nine rounds of budget cuts, built up record-high levels of debt and had three downgrades in their credit rating.

Fortunately, Missouri lawmakers can learn from our neighbors and take steps to control the cost of the tax cuts before they are implemented.

In particular, the business income exemption should be reversed. The provision creates "winners and losers" in Missouri's economy by giving certain businesses an unfair tax advantage, does not stimulate economic growth, and creates significant uncertainty regarding the cost of the bill.

By repealing the business income deduction, state lawmakers could stabilize state revenue and have more funding immediately available to support the fiscal year 2018 critical budget needs.

Footnotes

1. Tax Foundation Fiscal Fact, “Not in Kansas Anymore: Income Taxes on Pass-Through Businesses Eliminated,” May 29, 2012

2. Center on Budget & Policy Priorities, “Proposed Kansas Tax Break for Pass-Through Profits is Poorly Targeted And Will Not Create Jobs,” March 23, 2012

3. Kansas Center for Economic Growth, “A Guide to Comprehensive Tax Reform in Kansas”, December 2016 http://realprosperityks.com/wp-content/uploads/2013/02/KCEG_booklet_FINAL.pdf

4. See Missouri Budget Project, “Missouri Faces Additional Cuts to Services in Both Current Year, Fiscal Year 2018,” January 2018

5. Internal Revenue Service – Statistics of Income