

DECREASE the PERSONAL INCOME TAX RATE and IMPLEMENT TAX PARITY for PASS-THROUGH BUSINESSES

In today's uncertain economy, state tax policy is an important tool that can be used to encourage growth, investment, and feed innovation. It is a simple equation: Lower taxes equal more resources for business owners to invest in employees, equipment, research and development, helping them to maintain a competitive edge in a **global** economy. Reductions in the Personal Income Tax and Corporate Net Income tax rates will help create a business-friendly tax climate and prevent job loss and business migration to more business-friendly states. Implementing Section 179 expensing will give a major boost to Pennsylvania's 767,620 businesses who file at the pass-through rate. That group does not enjoy the same Section 179 expensing benefits given to Pennsylvania's C corporations.

PROBLEM: Governor Wolf's 2021-22 budget took a blunt instrument to PA's smaller and medium-sized businesses by proposing a 46% increase in the Personal Income Tax (PIT) rate from 3.07% to 4.49%. That subjects all those pass-through entities who file at the PIT to the 46% tax increase. Pass-throughs include Subchapter-S corporations, sole proprietorships, partnerships, LLC's, and independent contractors. As noted above, according to PA's Independent Fiscal Office, 2018 PIT statistics 767,620 businesses would file at the increased rate. For some of Pennsylvania's small businesses, still struggling due to the pandemic, the tax increase could be the death blow.

It is time to dispel the myths held by those who have never run a business or met a payroll. They mistakenly think businesses solve everything by "writing it off," and all business owners have a money spigot they can turn on and off at will. Nothing could be further from the truth.

- **Before the pandemic small businesses created 57,377 new jobs in 2019.**
- **Firms employing fewer than 20 employees experienced the largest gains, adding 34,585 new jobs.**

...U.S. Small Business Office of Advocacy, 2020 Pennsylvania Profile

BACKGROUND

One need only look as far as the findings from PNC's Spring Economic Outlook Survey, March 1, 2021 to see the overall impact of the pandemic across the country. The survey was conducted by telephone from 1/2/2021 to 2/2/2021, among small and mid-sized businesses with self-reported revenue of \$100,000 to \$250 million. Below you can see some of the damage uncovered by the 500 interviews.

- **Almost half (48%) say that they are facing challenges to stay in business.**
- **Nearly one-in-four (24%) small businesses do not believe they can stay afloat for another year under current economic conditions.**
- Nearly one in four (24%) small businesses reported they reduced their workforce last year and while most are not anticipated to be permanent layoffs, rehiring will be a slow process.
- Only 7% expect to increase the number of full-time employees in the next six months.
- 40% indicated that they plan to increase prices in the next six months.

Unfortunately for Pennsylvanians and the Commonwealth, according to Gus Faucher, Chief Economist, The PNC Financial Services Group, **"Business owners indicated that they would have to cope with these challenges in two ways that are potentially harmful for the broader economic recovery, slowing the rate of hiring and increasing prices for their customers."**

...*"With Small Businesses Permanently Changed By The Pandemic, Owners Looking To Vaccine-Driven Recovery, PNC Survey Shows"* <https://pnc.mediaroom.com/2021-03-01-With-Small-Businesses-Permanently-Changed-By-The-Pandemic-Owners-Looking-To-Vaccine-Driven-Recovery-PNC-Survey-Shows>

That does not have to happen if Pennsylvania's policy makers think creatively.

INNOVATIVE SOLUTION: Now is the time to reduce the 3.07% PIT rate, not increase it 46% to 4.49%. Small and mid-sized employers in the Commonwealth are experiencing enormous challenges as a result of the pandemic, economic fallout, and restrictions on business. Lowering the PIT rate may help mitigate some of the harm brought on by the pandemic.

It is important to help small business and medium-sized businesses because we are the backbone of the Pennsylvania economy. Consider the following statistics:

- 99.6% of all employers in Pennsylvania are small businesses defined as less than 500 employees.
- There are more than 1.1 million small businesses in Pennsylvania.
- Small businesses employed nearly 46.2% of Pennsylvania private-sector labor force in 2017 or 2.5 million employees.

...U.S. Small Business Office of Advocacy, 2020 Pennsylvania Profile

PROBLEM: Pennsylvania has not increased the Section 179 Expensing allowance for pass-throughs to conform with federal tax law like corporations under Pennsylvania law. Decoupling this change discourages business expansion, adds to overhead costs to separate Pennsylvania capital expense deduction calculations, and adds to significant on-going tracking of depreciation.

INNOVATIVE SOLUTION: MBA supports conforming to Section 179 Expensing to federal law. Section 179 is an important tool for small businesses and manufacturers because it allows the immediate expensing of the cost of qualifying property rather than depreciating these acquisitions over multiple tax years. When the total purchases in a year exceed a specific cap, the direct expensing allowance cannot be used. Pennsylvania Section 179 expensing should conform to the same amount permitted under the 2017 Tax Cuts and Jobs Act.

Now taxpayers can deduct \$1,000,000, with a phase-out threshold of \$2,500,000 on their federal taxes. This increase enjoyed bipartisan support and it is now a permanent part of the federal tax code. However, the same Pennsylvania taxpayers with pass-through businesses can deduct only \$25,000 with a phase-out of \$200,000 on their state taxes. **Pennsylvania is unique in being the only state that allows for full Section 179 expensing for large businesses while not allowing small businesses to do the same. This has created an inequity for small businesses in Pennsylvania and a barrier to innovation.**

Conformity of Pennsylvania Section 179 with Section 179 of the federal tax code will provide relief for small businesses and small manufacturers. Currently, without conformity, multiple sets of books are required adding to overhead costs. For example, Maryland builds their state tax code off of the federal tax code so only one set of books is required.

We fought long and hard at the federal level for permanency of Section 179 because the expensing allowance and the phase-out threshold changed at least 10 times between 2000-2017. Permanency and predictability help manufacturers and small businesses that make expensive capital acquisitions because it helps with cash flow, provides certainty for business planning, and simplifies and reduces the cost of compliance with the tax code.

BACKGROUND:

Sole proprietorships, Sub Chapter S corporations, limited liability companies (LLCs), and partnerships are called pass-through businesses because their net profits are passed directly through to the business owner and taxed on the owners' individual income tax returns.

	U.S. Businesses Utilizing Section 179 on the 2014 Federal Tax Form
C corporations	244,200
S corporations	945,900 (pass-throughs helped by Section 179)
Partnerships	296,200 (pass-throughs helped by Section 179)
Sole proprietors, farmers, rental	4,403,000 (pass-throughs helped by Section 179)

...Adapted from the "PA Fiscal Update, Compete PA Retreat," (Independent Fiscal Office, 2/27/2018)

Pass-Through characteristics:

- They are more likely to be smaller firms.
- Most pass-through employment is either self-employment (33.6%) or at firms with 1 to 100 employees (38.7%).
- The vast majority of manufacturing firms are pass-through businesses.

...adapted from The Tax Foundation, ("Overview of Pass-through Businesses in US," Kyle Pomerleau, 2015, based on 2011 census data)

- Almost 66% of manufacturers are organized as pass-through entities in the most recent data. The remainder are C corporations.

...National Association of Manufacturers, (NAM Manufacts)

PROBLEM: Pennsylvania's high Corporate Net Income tax rate is one of several red flags observed by businesses looking to move to PA. "Pennsylvania has one of the least competitive business tax environments in the country. For 2021, we rank 43rd in the nation in the Tax Foundation's "Corporate Tax Ranking." At 9.99 percent, we have the highest non-graduated Corporate Net Income Tax (CNIT) rate in the country. While we appreciate your proposal to lower this rate, tying the rate reduction to combined reporting – a policy that adds complexity, uncertainty, and cost to business – ultimately further negatively impacts Pennsylvania's competitive standing."

...Compete PA's letter to Governor Wolf, February 15, 2021

SOLUTION: MBA, in concert with the Compete PA Coalition, supports a reduction in the 9.99% Corporate Net Income (CNI) tax rate.

...Compete PA is a coalition comprised of statewide and regional business groups, small and medium-sized businesses, as well as Fortune 500 companies. The coalition, which represents more than half the Commonwealth's private sector employers, was formed in 2005 to help create a competitive business tax climate that encourages job growth in Pennsylvania.

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