PROP 208 - INVEST IN ED IS INVESTING IN THE ARIZONA ECONOMY

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A POLICY BRIEF BY:

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For years now, the Arizona legislature has failed to sufficiently invest in education. Our state ranks 50th in funding per student,[2] while our teacher-student ratios are some of the highest in the country and our public teacher salaries among the lowest.[3] These failures to invest in our children, their teachers, and their schools hurt Arizona's economy. We need to develop a workforce ready for the 21st century economy, but we can't do that when over 20% of students who enter high school don't graduate within four years.[4] (Arizona is tied for the second lowest high school graduation rate in the country.)

Prop 208 - Invest in Ed levies an additional 3.5% income tax surcharge for Arizona taxpayers with *taxable income* over $250,000 (or over $500,000 for taxpayers who are filing joint returns). The tax collected from this surcharge provides much-needed investments in Arizona's K-12 education system.

Opponents of Prop 208 - Invest in Ed have claimed that the initiative would hurt small businesses in Arizona and slow job creation, but the truth is the vast majority of Arizona business owners would not face any tax increase under the initiative. Further, investments in public education and the public sector are themselves important for creating a healthy economy that allows all of our residents to thrive.

The Vast Majority of Business Owners Won't Face a Tax Increase Under Prop 208 - Invest in Ed

Let's start with what Prop 208 - Invest in Ed does not do. It does not change the corporate tax rate at all. Businesses organized as corporations and paying corporate taxes will not face any tax increase.

But it is also true that many small businesses are not corporations, but rather partnerships and limited liability corporations. For these business entities, no tax is paid by the business itself. Rather, this business income is taxed on the individual returns of partners and shareholders. Arizona also follows federal law and provides shareholders of closely-held corporations the choice to report income on this "pass-through" basis by allowing them to elect what is called "s-corp" treatment.

The vast majority of businesses owners taxed on this pass-through basis will also not experience any tax increase due to Prop 208 - Invest in Ed because most small business owners make less than $250,000 a year (or $500,000 a year for those filing a joint return). In 2018, *less than 13% of Arizona's individual tax returns reporting partnership or business income had more than $200,000 in adjusted gross income.*[5] And only about 3% of Arizona tax returns reporting business or partnership income had adjusted gross income of $500,000 or more.

Because the Prop 208 - Invest in Ed surcharge only applies to those with *taxable income* above $250,000 even single taxpayers with an adjusted gross income of $250,000 would not face additional tax because their adjusted gross income is reduced by the standard deduction (or itemized deductions) and by a special deduction available to many pass-through business owners. (See sidebar on page 3 for example).

This small number of high-income business owners, however, earns the majority of pass-through income. The top 1% of earners in the United States report about 70% of partnership income, and the vast majority of pass-through income is earned by the top 20% of income earners.[6] According to the Brookings Institution, "[i]ndividuals in the bottom 80 percent earn virtually no pass-through income."[7]

Pass-Throughs Aren't Just for Small Businesses

Efforts to portray Prop 208 - Invest in Ed as a tax on small businesses also inaccurately suggest that all pass-through income is earned by small businesses. In fact, many large businesses are also organized as pass-throughs. According to the Tax Foundation, more businesses with over 500 employees are organized as pass-throughs than traditional c-corporations.[8] And it is these large entities that earn the majority of partnership and s-corp income.[9] (It remains true the majority of income earned by sole-proprietorships is from small businesses as that business form does not lend itself well to scale.[10])

Large businesses that are organized as pass-throughs include household names, like the national retail chain Hobby Lobby.[11] Large financial and professional service providers are frequently structured as partnerships, including hedge funds and private equity funds, as well as law firms and accounting firms.[12]

Prop 208 - Invest in Ed Applies to Taxable Income, Not Gross Profits

For a variety of official purposes, the definition of a small business is often related to the number of employees a business has or the business' gross receipts. As a result, many small businesses owners may worry that they are subject to the Prop 208 - Invest in Ed increase even though their taxable income does not exceed the $250,000/$500,000 threshold. But the Prop 208 - Invest in Ed surcharge does not apply to gross receipts, but rather to the often much lower "taxable income" of business owners.

Here's how this would work for the married owner of a very successful coffee shop with $700,000 in gross receipt.

Gross receipts or sales	**$700,000**
Deduction for cost of goods sold	**($200,000)**
Deductions for payroll, including salary & benefits	**($200,000)**
Deductions for other business expense, including current full expensing of investments in machinery & equipment, property rental or mortgage expenses, utility payments, insurance expenses, & advertising.	**($100,000)**
Adjusted Gross Income	**$200,000**
The Standard Deduction	**($24,800)**
Deduction of Business Income Under 199A	**($35,040)**
Taxable Income	**$140,160**

As a result, this business owner is well below the Prop 208 - Invest in Ed surcharge threshold, though her business had $700,000 in gross receipts.

The 2017 Tax Cut and Jobs Act Gave Many Pass-Through Entities A Large Tax Break

Finally, owners of small businesses organized as pass-throughs benefit from a substantial reduction in taxable income due to a generous tax break enacted in 2017. This provision, known as Section 199A, allows many pass-through businesses to deduct up to 20% of their business income, on top of all the other deductions available for the costs of doing businesses. In this respect, eligible small business owners are much better off than equivalent wage-earners, who cannot avail themselves of this deduction. Section 199A has been criticized as inviting significant abuse and its exact limits are byzantine. Generally speaking, however, the deduction is available to all those who receive pass-through business income and whose taxable incomes are below $163,300 for single taxpayers or $326,600 for those filing joint returns, and it is also available for many business owners whose taxable income exceeds these thresholds.

Prop 208 - Invest in Ed is an Investment in the Future of Arizona

Prop 208 - The Invest in Education Act makes an investment in Arizona's future, our children. The Act asks those who have benefited the most from our growing economy to pay their share to ensure our future prosperity. Now is the right time to make that investment.

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Citations

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2 Daniel Farrie, et al., Making the Grade 2019: How Fair is School Funding in Your State 4 Fig. 1 (2019), available at https://edlawcenter.org/assets/Making-the-Grade/Making%20the%20Grade%202019.pdf (showing Arizona 50th on a cost-adjusted per pupil funding level).
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4 National Center for Education Statistics, Fast Facts, High School Graduation Rates, https://nces.ed.gov/fastfacts/display.asp?id=805 (last visited Sept. 17, 2020).
5 SOI Tax Stats, Historic Table 2, Individual Income and Tax Data, by State and Size of Adjusted Gross Income, 2018, Arizona, https://www.irs.gov/statistics/soi-tax-stats-historic-table-2
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7 Id.
8 Kyle Pomerlaeu, Pass-Through Businesses Are Not Always Small Businesses (2014), https://taxfoundation.org/pass-through-businesses-are-notalways-small-businesses/
9 Krupkin & Looney, supra note 7.
10 Id.
11 Drew Desilver, What is a 'Closely Held Corporation,' Anyway, and How Many Are There? (2014), https://www.pewresearch.org/fact-tank/2014/07/07/what-is-a-closely-held-corporation-anyway-and-how-many-are-there/
12 Krupkin & Looney, supra note 7.
13 Section 199A allows a deduction of 20% of a taxpayer's qualified business income (generally income earned from eligible pass-through businesses). However, the deduction cannot exceed 20% of a taxpayer's taxable income (calculated without regard to the § 199A deduction). I.R.C. §199A(a)(1). Here, the taxpayer has $200,000 in qualified business income, so it might seem like the taxpayer would be eligible for a $40,000 deduction (20% X $200,000). However, the taxpayer's taxable income (calculated without regard to the § 199A deduction would be $175,800 ($200,000 in income minus the $24,800 standard deduction). As a result, the most this taxpayer can deduct is 20% of $175,800, or $35,040.