Picking Winners and Losers: Missouri's Business Income Deduction is Bad Tax Policy

Missourians want good schools for their kids, safe roads and bridges, and affordable health care for their families. To support our state's public services, Missourians expect a fair tax policy where everyone pays their fair share. Eliminating Missouri's "LLC loophole" would move our state towards a more fair tax structure with the resources our state needs to help all Missourians prosper.

LLC Loophole is Unfair

Salaried employees and wage earners pay income tax on nearly 100% of earnings, but certain Missourians can take advantage of a recently imposed tax loophole to game the system.

The business income deduction included in Senate Bill 509, enacted in 2014, 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.[1]

For that select group, 20% of their income would be exempt from tax, while Missouri families and other Missouri companies would continue to pay state tax on the majority of their income.[2] As a result, the exemption creates an incentive for businesses to change their corporate structure in order to avoid paying state tax. This exemption is known as the LLC Loophole.

The Kansas Experiment: The LLC Loophole Creates LLCs, Not Jobs

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 did not spur economic or job growth.

In fact, according to the Kansas Center for Economic Growth:

> "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]

Tax analysts across the political spectrum agree that this provision does nothing to stimulate the economy, but simply encourages tax avoidance by giving certain businesses an unfair tax advantage.

As the Tax Foundation notes: "There is no sound economic justification for treating two types of business activity so dramatically differently."[4]

The Kansas legislature reversed its tax cuts in 2017 after enacting nine rounds of budget cuts, accruing record-high levels of debt and seeing three downgrades in the state's credit rating.

Loophole Increases State's Fiscal Uncertainty

Missouri faces significant fiscal uncertainty this year, which will likely continue as the tax cuts from SB 509 continue to be phased in.

- The cost of SB 509 is likely to be higher than anticipated by the bill's fiscal note.
- 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.

Missouri can help stop the bleeding by eliminating the LLC loophole before additional cuts go into effect.

NOTES

1. Senate Bill 509 was passed in the 2014 legislative session. The package of tax cuts included in the bill were to be phased in over at least a five-year period. As passed, SB 509 would have allowed a 25% deduction of business income when fully phased in.

2. In 2018, the legislature passed HB 2540. Among other provisions, it reduced the business income deduction to 20%.

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

5. Internal Revenue Service – Statistics of Income