A Sense of Scale: Small Businesses in Alabama

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Late in Alabama's 2009 legislative session, Rep. DuWayne Bridges, R-Valley, brought a lighted candle onto the House floor. The flame was burning, Bridges said, in memory of all of the small businesses that had been taxed to death in Alabama. Bridges used the candle to illustrate his opposition to a bill that would have ended the state **sales tax** on groceries and replaced the revenue by ending higher-income taxpayers' ability to deduct federal **income taxes** on their state income taxes. (The bill later lost on a procedural vote.)

The candle incident prompted light-hearted banter among lawmakers, but it also pointed to larger questions about small businesses in Alabama. What *are* small businesses, anyway? How are they taxed in Alabama? And do small businesses survive or fail because of taxes, or do other factors play larger roles?

'Small business': A term with no set meaning

Lawmakers often debate how a bill would affect small businesses, but no single official definition of "small business" exists. Some meanings look to how many people the business employs, while others focus on the entity's annual receipts or tax status. The U.S. Small Business Administration (SBA) definitions of "small business" vary widely by industry. In general, the SBA classifies manufacturers that employ 500 or fewer people and non-manufacturing businesses that have less than $7 million in annual receipts as small businesses.

Some definitions are so broad that almost every business in the United States can be classified as a small business. Under the SBA definition of 500 or fewer employees, 99.7 percent of the nation's employer firms (and 97.2 percent of Alabama's) count as small businesses, according to 2007 data from the U.S. Census Bureau. The Internal Revenue Service (IRS) labels any **S corporation**, no matter how much it makes, as a small business corporation. And some people use the term "small business" to refer broadly to all entities set up as an S corporation, **partnership** or **limited liability company (LLC)**, even though some of those entities make hundreds of millions of dollars in profit each year.

Despite the expansive federal definitions, most American small businesses truly are small. Fewer than 1 percent of the nation's tax filers with small business income report incomes above $1 million, according to the Tax Policy Center (TPC). Nationwide, about 90 percent of such filers report annual incomes below $200,000, the TPC found, and more than half report annual incomes below $75,000.

Keywords

business privilege tax – a tax on the net worth of companies doing business in Alabama. The tax ranges from a minimum of $100 a year to a maximum of $15,000 a year for most companies.
corporate income tax – a tax on the taxable profits of a corporation. Alabama's 6.5 percent tax applies to the portion of corporate profits that are attributable to business activities that take place in the state.
corporation – a business that issues stock to shareholders, acts as a legal "person" and generally protects shareholders from individual liability for its actions. By default, it is subject to corporate income taxes.
income tax – a tax on earned income (salaries or wages) and unearned income (dividends, interest, etc.).
limited liability company (LLC) – a company that is run by its members or outside managers, has limited liability like a corporation, and can choose to pay taxes like either a partnership or corporation.
partnership – a business in which owners pass gains and losses through to their individual income taxes.
payroll tax – a tax on wages that is used to finance unemployment insurance, worker compensation, disability insurance, Social Security and Medicare.
S corporation – a corporation that chooses to report gains and losses directly on shareholders' individual income tax returns, as partnerships do. S corporations file under Subchapter S of the Internal Revenue Code and are not subject to corporate income taxes.
sales tax – a tax levied by a state or locality on the retail price of an item, collected by the retailer.
sole proprietorship – a business owned by one person (or a married couple) who passes business gains and losses through to the person's individual income taxes.

Many small businesses are set up as LLCs. The first American LLCs were established in Wyoming in 1977, and the business form has exploded in popularity since then. LLCs have no limit on the number of owners – known as "members" – or on the citizenship of those owners. LLCs also allow members to decide if they wish to run the company themselves or bring in outside management to do it for them. And as their full name suggests, LLCs limit members' personal liability for the company's actions and debts.

S corporations are a less common form for small businesses. They are created when a **corporation** files with the IRS to be taxed in a way that allows it to avoid paying **corporate income taxes**. S corporations have only one class of stock and may have no more than 100 shareholders, all of whom must be U.S. citizens or legal residents. (Some trusts, estates and nonprofits also can qualify as shareholders in certain cases.) Like LLCs, S corporations also protect shareholders from personal liability for the company's actions and debts.

How are LLCs and S corporations taxed?

Before they pay a dime in taxes, both LLCs and S corporations can deduct much of the cost of doing business from their tax bills. The entities are allowed to deduct employee wages, benefits, rent, advertising and other relevant business expenses before calculating the profits distributed to owners. They also have many ways to reinvest profits into their businesses without owing taxes on that money. And when tax time rolls around, Alabama businesses pay in a state that has the lowest per capita state and local taxes in the nation.

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LLCs enjoy tax flexibility that is unavailable to other forms of businesses. By default, LLCs are taxed like **sole proprietorships** (single-member LLCs) or partnerships (multi-member LLCs), but they also can choose to be taxed like corporations instead if their owners find that to be advantageous. Most LLCs opt for the default status, under which profits and losses pass through directly to members. Gains and losses usually are allocated proportionally to members. That means if Kate owns 75 percent of an LLC, she can claim 75 percent of the LLC's profits and losses.

By default, LLC members pay individual income taxes – both federal and state – on their profits. Members also owe self-employment **payroll taxes** on their share of earnings. Like all self-employed people, they pay an amount equal to both the employer's share and the employee's share of payroll taxes. Alabama LLCs owe a **business privilege tax** on their net worth, but they do not owe federal or state corporate income taxes unless they choose to be taxed like a corporation.

S corporations do not pay corporate income taxes, and some owners use loopholes to reduce their payroll tax payments substantially. Like LLC members, S corporation owners report their business earnings on their individual income taxes. They also pay Alabama's business privilege tax. Unlike LLC owners, however, S corporation owners can divide their earnings into compensation (which is subject to payroll taxes) and profit shares (which are not). Federal rules require owners to pay themselves "reasonable compensation," but the Government Accountability Office recently estimated that the federal government lost about $3 billion in payroll taxes in 2003 and 2004 because some S corporation owners under-reported their compensation.

Life and death: The small business cycle

Small businesses succeed and fail every day across the nation. Firms with fewer than 500 workers employ more than half of the private sector and have been responsible for almost two-thirds of net job creation in the last 15 years, according to the SBA. But the universe of small businesses is far from static. Firms with fewer than 500 workers created an average of almost 5 million new jobs per quarter between 1992 and 2009 through openings or expansions, according to data from the Bureau of Labor Statistics. But they also caused an average of 4.8 million job losses per quarter via closings or contractions. Some small businesses grow into global success stories, but many others disappear just a few months or years after they debut.

State and local taxes have little effect on business profits and growth decisions. Nationally, state and local taxes account for only 2 percent of business costs, according to the Center on Budget and Policy Priorities. In Alabama, those taxes help support education, job training, roads, police and fire protection, and other public services that help small companies grow and make the state a better place to do business.

In the end, small businesses rise or fall based not on taxes but on their business model and the state of the economy. To succeed, businesses need access to the necessary labor and supplies, access to markets for their products and services, and sufficient capital. State and local taxes are a minor factor compared to business basics. Companies do better when public infrastructure is strong and when consumers have more income to spend. To that end, state tax policies could help small businesses keep the lights on by putting more money into the pockets of low- and middle-income people while protecting funding for the public services that provide the backbone for future growth.

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