

Taxation of Pass-Through Businesses

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The vast majority of US businesses are pass-through entities such as sole proprietorships, partnerships, and S corporations. Unlike C corporations, these firms are not subject to the corporate income tax. Instead the owners include their share of profits as taxable income under the individual income tax, which is taxed up to the maximum rate of 39.6 percent rate.

This year, Congress will consider what may be the biggest tax bill in decades. This is one of a series of briefs the Tax Policy Center has prepared to help people follow the debate. Each focuses on a key tax policy issue that Congress and the Trump administration may address.

ADVANTAGES OF PASS-THROUGH ENTITIES

Pass-through businesses generally face the same tax rules as C corporations for inventory accounting, depreciation, and other provisions that measure business profits. But organizing as a pass-through business has several advantages. The first is that income is subject only to a single layer of income tax at the owner's rate. In contrast, profits of C corporations are taxed twice: at corporate income tax rates of up to 35 percent and again at rates up to 23.8 percent when paid out as dividends or when

shareholders sell stock and realize capital gains. Pass-through status also allows individuals to deduct business losses against income from other sources, subject to some limitations for "passive losses." In contrast, C corporation losses can only offset income earned inside the corporation. However, C corporation losses may be carried back for up to two years or carried forward for as long as 20 years and deducted against business profits in previous or future years.

TYPES OF PASS-THROUGH ENTITIES

Sole Proprietorships: A business with a single owner does not file a separate tax return, but rather reports its net income on Schedule C of the owner’s individual tax return. Generally all net income from sole proprietorships is also subject to payroll taxes under the Self Employed Contributions Act (SECA).

Partnerships: Partnerships file an entity-level tax return, but profits are allocated to owners who report their share of net income on Schedule E of their individual tax returns. Under “check the box” regulations instituted by the Treasury Department in 1997, limited-liability companies (LLCs) can elect to be taxed as partnerships. General partners pay SECA tax on all their net income, while limited partners are subject to SECA tax only on compensation for their labor.

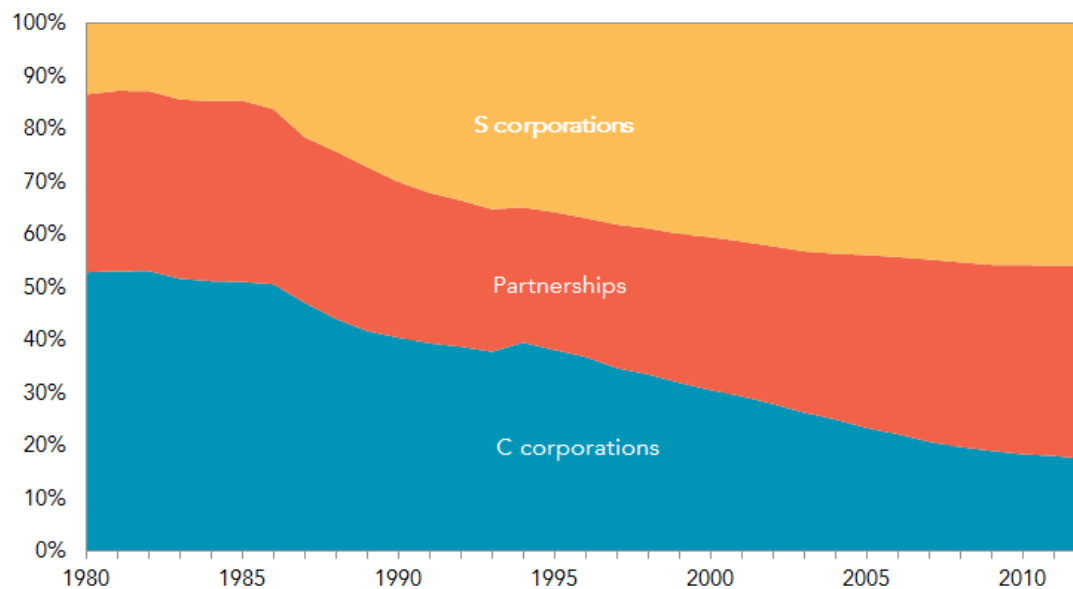
S Corporations: These firms file a corporate tax return but profits flow through to their shareholders personal

income tax. S corporations cannot have more than 100 shareholders, who must be US citizens or residents or certain estates, trusts, and tax-exempt organizations. S corporation owners do not pay SECA tax on their profits, but are required to pay themselves “reasonable compensation,” which is subject to the regular Social Security and Medicare payroll tax.

GROWTH IN PASS-THROUGH BUSINESSES

The share of business activity represented by flow-through entities has been rising since the passage of the Tax Reform Act of 1986. Sole proprietorships, by far the most common type of business, accounted for 72 percent of all businesses in 2012, but received just 4 percent of total business revenue. More than 80 percent of all other businesses were organized as pass throughs in 2012—up from 49 percent in 1985 (figure 1). During that period, the share of business receipts going to pass-through entities increased from 9 percent to 36 percent (figure 2).

FIGURE 1
Share of Business Returns by Type
1980–2012



Source: Internal Revenue Service, Statistics of Income Division, Integrated Business Data, Table 1.



WHO OWNS PASS-THROUGH BUSINESSES?

People often think of pass-through firms as small businesses. While about two-thirds of the 38 million households who report business income on their individual tax returns are sole proprietors, business income is just a small fraction of their total income. For instance, the [Tax Policy Center estimates](#) that about one-quarter of households with \$75,000-\$100,000 in total income report some business income on their individual returns. However, for more than nine out of 10 households at that income level, business income accounts for less than 10 percent of their adjusted gross income (AGI). On average, those middle-income households report only about \$7,300 in net business income.

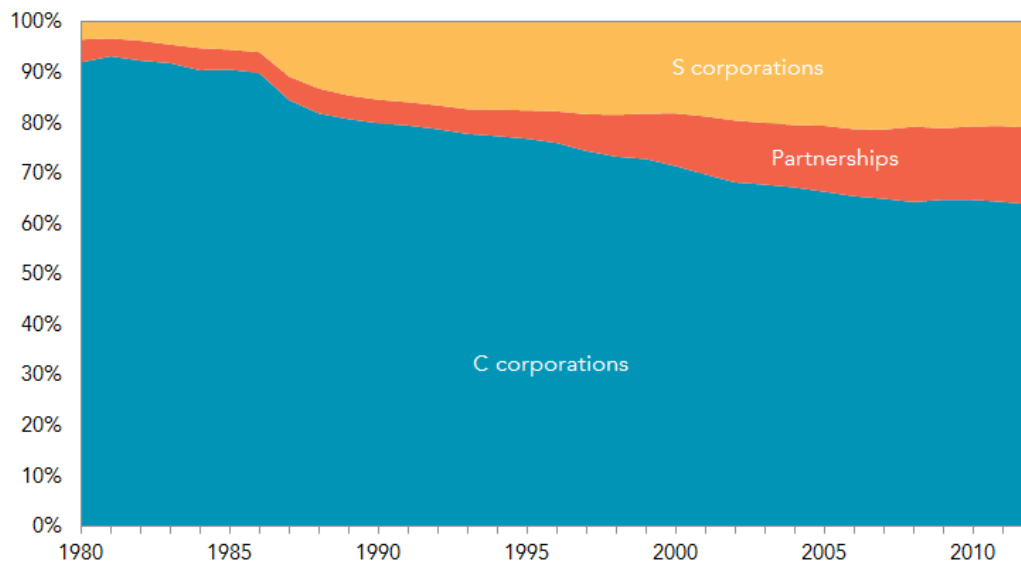
Many of these taxpayers don't have businesses at all. Rather, they may receive occasional income from the

rental of a vacation home, or from the sale of odds and ends on eBay, which they report as business income. A [2011 Treasury study](#) estimated that only about half of those who filed a sole proprietorship tax return really ran a business.

By contrast, upper-income taxpayers receive the bulk of business income from pass-through enterprises. Households making \$200,000 or more account for nearly 80 percent of business income reported on individual income tax returns, and 60 percent goes to those making \$500,000 or more. Among those making \$1 million or more, 80 percent report business income averaging more than \$810,000, and more than one-quarter generate at least half of their AGI that way. This high-income group comprises doctors, lawyers, consultants, and other professionals, and at the very highest end, partners in hedge funds or other investment firms.

FIGURE 2

Share of Business Receipts by Type 1980–2012



Source: Internal Revenue Service, Statistics of Income Division, Integrated Business Data, Table 1.



PROPOSALS TO CHANGE THE TAXATION OF PASS-THROUGH BUSINESSES

Recent tax reform proposals would change the taxation of pass-through businesses. The House Republican tax reform [plan](#) released in June, 2016 would reduce the top individual income tax rate to 33 percent, reduce the corporate rate to 20 percent, and cap the tax rate on profits of pass-through businesses at 25 percent. President Trump's revised campaign [plan](#) would reduce the top individual income tax rate to 33 percent and allow owners of pass-through businesses to elect a flat rate of 15 percent.

The big differences between the top rate on pass-through business income and the top rate on wages in these plans would create a strong incentive for many workers to receive compensation from their current employer

through a pass-through business rather than in the form of higher-taxed wages.

To stem such tax avoidance, both plans include unspecified provisions aimed at preventing people from gaming the new rate structure. However, even current-law rules are very difficult to enforce, and the much larger rate differential under the Trump and House GOP plans would result in greater tax avoidance.

The recent experience in Kansas illustrates this problem. In 2012 the state reduced its income tax rates and completely eliminated income taxes for pass-through business. The state expected that 191,000 taxpayers would benefit from the pass-through provision, but [almost 400,000 filers](#) claimed the exemption—a major contributing factor to the \$700 million decrease in personal income tax revenue.