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Pass-Through Businesses: Data and Policy

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Key Findings

- The majority of companies in the United States are pass-through businesses. These businesses are not subject to the corporate income tax; instead, their income is reported on their owners' tax returns and subject to the individual income tax.
- Over the past thirty years, the pass-through business sector has expanded significantly. Pass-through businesses now earn more net income than traditional C corporations and employ the majority of the private-sector workforce.
- On the federal level, pass-through businesses are subject to a top marginal tax rate of 44.6 percent. This means that, in most U.S. states, pass-through businesses can face marginal tax rates that exceed 47 percent.
- Some policymakers have expressed interest in taxing some large pass-through businesses as C corporations. However, there are strong theoretical and economic arguments for the current tax treatment of pass-through businesses, which are not subject to the problematic double tax regime faced by C corporations.
- On the flip side, some lawmakers have proposed creating a new, lower tax rate for pass-through business income. Aside from concerns that this approach would create opportunities for tax avoidance, it is also difficult to justify why income from pass-through businesses should be subject to lower tax rates than income from wages and salaries.

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Introduction

Much of the tax reform debate in the United States centers on the federal corporate income tax. However, many people are not aware that the vast majority of businesses in the U.S. are not subject to the corporate income tax at all.

Over 90 percent of businesses in the United States are pass-through businesses, whose income is reported on the business owners' tax returns and is taxed under the individual income tax. These businesses earn the majority of all business income in the U.S. and employ over half of the private-sector workforce in 49 out of 50 states.

Although they are not subject to the corporate income tax, many pass-through businesses still face a considerable tax burden on their investments and profits. Pass-through businesses are subject to both the federal individual income tax, with a top rate of 43.4 percent, and state and local income taxes, with rates ranging up to 13.3 percent.

As the tax reform debate heats up in 2017, the question of whether to change the tax treatment of pass-through businesses will pay a central role. As this paper will argue, there is a strong case to be made for keeping the current system of taxing pass-through businesses: a single layer of tax, levied at the same rates that apply to wages and salaries.

What Are Pass-Through Businesses?

Under the U.S. tax code, several types of businesses are not subject to the corporate income tax. Instead of paying taxes on the business level, these companies "pass" their income "through" to their owners. The business owners are then required to report the business income on their personal tax returns, so that the business income is taxed under the individual income tax.

There are three major categories of pass-through businesses: sole proprietorships, partnerships, and S corporations.[1] All three categories of pass-through business are taxed in a similar manner; they are distinguished from one another by their legal form of organization, as well as the number of owners.

1 These categories do not always line up precisely with the business categories defined by state law. For instance, limited liability companies – a legal business form in all fifty states – can be classified as sole proprietorships, partnerships, S corporations, or C corporations for federal tax purposes, depending on the circumstances.

Table 1.

Major Types of Pass-through Businesses

Category	Description
Sole Proprietorship	An unincorporated business owned by a single individual. Individuals report sole proprietorship income on Schedule C of the 1040 tax form.
Partnership	An unincorporated business with multiple owners, either individuals or other businesses.
S Corporation	A domestic corporation that can only be owned by U.S. citizens (not other corporations or partnerships) and can only have up to 100 shareholders.

It is useful to contrast pass-through businesses with "C corporations," or companies that are subject to the corporate income tax. Unlike pass-through businesses, C corporations can face up to two layers of tax on their income. First, income earned by a C corporation is taxed under the corporate income tax in the year it is earned. Then, when a C corporation distributes its income to shareholders in the form of dividends, or when the shareholders sell their stock and realize a capital gain, the income can be taxed a second time, under the individual income tax. By contrast, income earned by pass-through businesses is generally subject to one layer of tax, on the owners' tax returns, without a second layer of tax on the business level.[2]

Another important difference between pass-through businesses and C corporations has to do with tax timing. In general, the owners of pass-through businesses are required to pay taxes on a business's income in the same year the income is earned. This is also the case for the first layer of tax on C corporations, the corporate income tax, which is paid in the same year that a corporation earns income. However, shareholders of C corporations are able to defer the second layer of tax – the individual income tax on dividends or capital gains – until a corporation distributes its profits or until a shareholder realizes a gain.

Pass-Through Businesses are a Major Part of the U.S. Economy

The vast majority of businesses in the United States are pass-through businesses.[3] In 2014, out of the 30.8 million private business establishments in the United States, 28.3 million were pass-through businesses (Figure 1).[4]

2 However, there are certain cases in which pass-through businesses can be subject to entity-level income taxes, on both the federal and state levels. For instance, the Bipartisan Budget Act of 2015 allowed the IRS to collect income taxes on partnership income at the firm level, in certain situations. In addition, S corporations are sometimes subject to entity-level income taxes levied by states.

3 Here, "business" and "business establishment" are defined as "a single physical location at which business is conducted or services or industrial operations are performed." See: U.S. Census Bureau, "Universe of County Business Patterns," 2016, http://www.census.gov/programs-surveys/cbp/technical-documentation/methodology/universe-of-cbp.html.

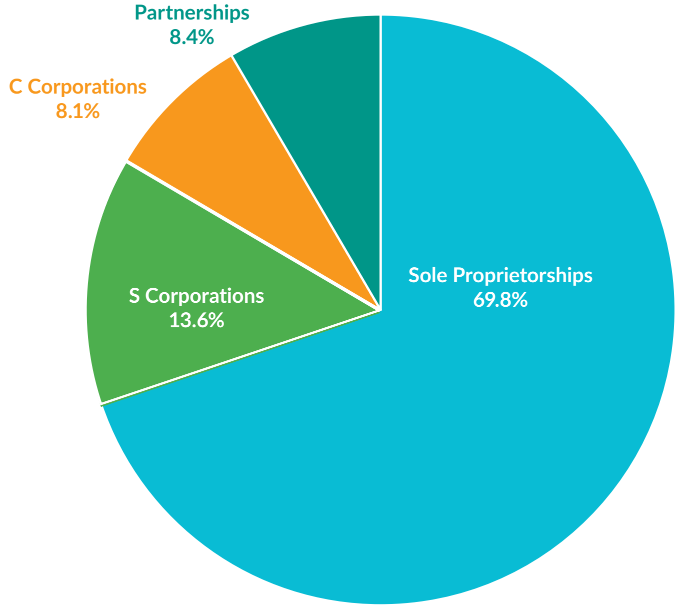
4 Data compiled from U.S. Census Bureau, "County Business Patterns: 2014," http://www.census.gov/data/datasets/2014/econ/cbp/2014-cbp.html; U.S. Census Bureau, "Nonemployer Statistics," https://www.census.gov/econ/nonemployer/download.htm. "Private businesses" refers to all business establishments encompassed in these datasets, excluding "nonprofit," "government," and "other" establishments.

The most common form of pass-through businesses in the United States is the sole proprietorship. There were 21.5 million sole proprietorships in 2014, accounting for 69.8 percent of all private businesses. On the other hand, C corporations are relatively uncommon. Only 2.5 million businesses filed taxes as C corporations in 2014, or 8.1 percent of all private businesses.

Figure 1.

The Majority of Companies in the U.S. are Pass-Through Businesses

Share of Private Business Establishments by Form, 2014



Source: Census County Business Patterns (2014) and Non-Employer Statistics (2014)

In addition, pass-through businesses are also responsible for more than half of private-sector jobs in the U.S. (Figure 2). In 2014, 57.3 percent of the U.S. private-sector workforce was employed or self-employed at a pass-through business.[5] In numerical terms, U.S. pass-through businesses employed 73.0 million people in 2014, compared to 54.3 million employees of C corporations.[6]

Within the pass-through sector, in 2014, S corporations had the most employees: 32.5 million people, or 25.5 percent of the private sector workforce. Although sole proprietorships are the most common form of business in the U.S., they accounted for only 19.6 percent of all private-sector jobs. This is because most sole proprietorships consist of one self-employed individual, without any other employees.

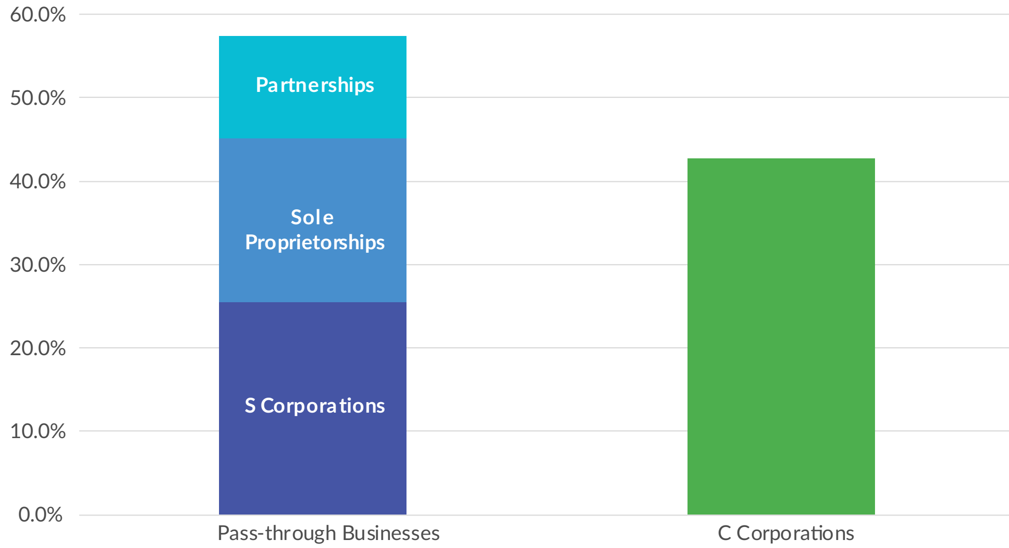
5 Here, “workforce” is used to refer to the population of employed individuals, and does not include unemployed individuals seeking work.

6 These figures may double count some individuals who were simultaneously self-employed as a sole proprietorship and employed by a different business as well.

Figure 2.

Pass-through Businesses Employ More than Half of the Private-Sector Workforce

Share of Private Sector Employment, by Business Form (2014)



Source: Census County Business Patterns (2014) and Non-Employer Statistics (2014)
Note: Due to data constraints, some employees may be counted more than once

In 49 out of 50 states, pass-through businesses employ over 50 percent of the private workforce. The one exception is Hawaii, where pass-through businesses account for 49.9 percent of private-sector jobs. In four states, pass-through businesses are responsible for over 65 percent of the private-sector workforce: Montana (68.6 percent), South Dakota (66.3 percent), Idaho (65.4 percent), and Vermont (65.2 percent).

The Growth of the Pass-Through Sector

The dominance of pass-through businesses in the U.S. economy is a relatively recent phenomenon. In 1980, C corporations accounted for the overwhelming majority of U.S. business income, earning over three times as much as partnerships, S corporations, and sole proprietorships combined (Figure 3).[7]

However, the share of business income earned by pass-through businesses began to grow rapidly in the late 1980s. One important cause of this shift was the Tax Reform Act of 1986 (TRA86), which lowered the top individual income tax rate from 50 percent to 28 percent, making it more profitable than beforehand to operate as a pass-through business.[8]

7 Internal Revenue Service, "SOI Tax Stats – Integrated Business Data," Table 1, https://www.irs.gov/uac/soi-tax-stats-integrated-business-data.

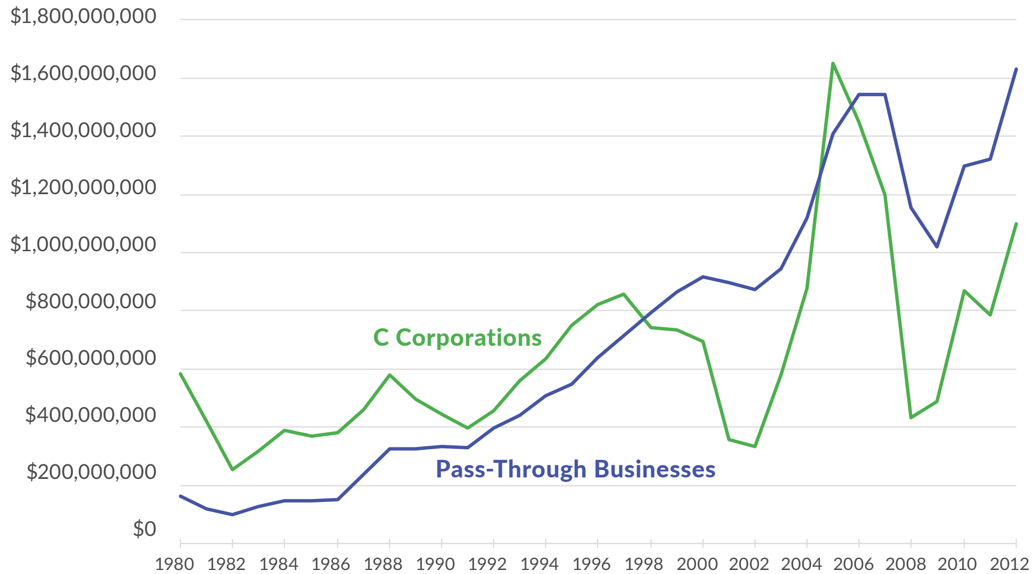
8 P.L. 99-514. The Tax Reform Act of 1986 also lowered the top corporate income tax rate from 46 percent to 34 percent. For a brief discussion of the effects of TRA86 on business forms, see: Congressional Budget Office, "Taxing Businesses Through the Individual Income Tax," 2012, https://www.cbo.gov/sites/default/files/112th-congress-2011-2012/reports/43750-TaxingBusinesses2.pdf.

By 1998, pass-through businesses had begun to earn a greater share of business income than C corporations. Since then, pass-through businesses have continued to earn more income than C corporations in every year except 2005. In 2012, pass-through businesses earned $1.63 trillion in net income, compared to $1.10 trillion of net income earned by C corporations.[9]

Figure 3.

Pass-Through Businesses Now Earn More Net Income Than C Corporations

Net Income (Less Deficit) of U.S. Businesses, by Form, Thousands of 2015 Dollars (1980-2012)



Source: IRS, *Statistics of Income*, Integrated Business Data

The rapid growth of the pass-through sector in recent decades is also apparent from the number of tax returns filed by different business forms (Figure 4).[10] In 1980, there were more tax returns filed by C corporations (2.2 million) than by partnerships (1.4 million) and S corporations (0.5 million) combined. By 2012, there were *over four times* as many returns filed by partnerships (3.4 million) and S corporations (4.2 million) as the returns filed by C corporations (1.6 million).

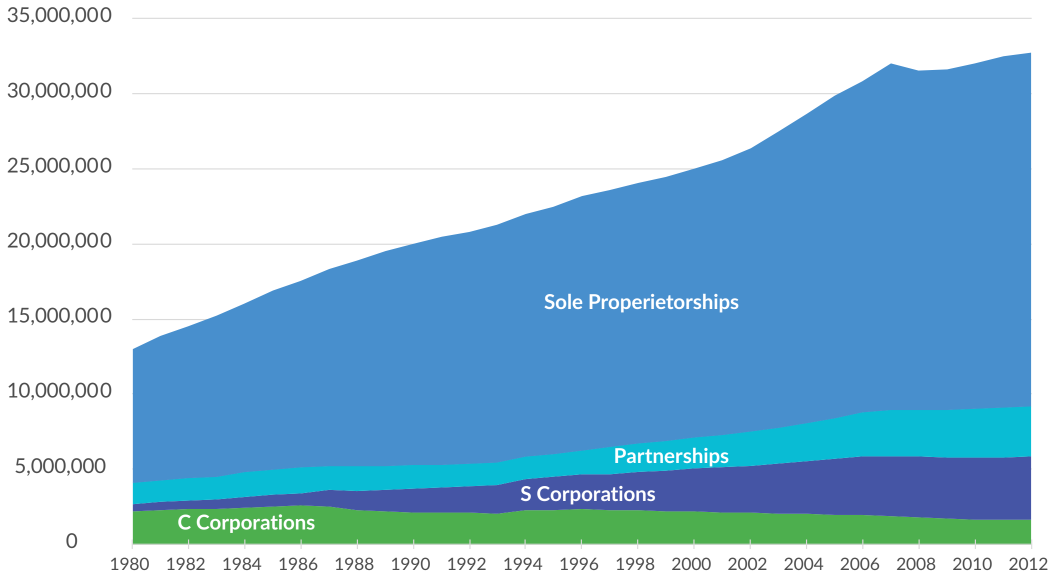
Overall, between 1980 and 2012, the number of pass-through businesses filing tax returns rose substantially, from 10.9 million businesses to 31.1 million. Concurrently, the share of all business tax returns filed by C corporations fell dramatically, from 16.6 percent in 1980 to 4.9 percent in 2012.

9 Both figures are adjusted to 2015 dollars.
10 Internal Revenue Service, "SOI Tax Stats – Integrated Business Data," Table 1, https://www.irs.gov/uac/soi-tax-stats-integrated-business-data.

Figure 4

In Recent Decades, the Number of Pass-Through Businesses Has Grown Significantly

Number of Tax Returns, by Business Form (1980-2012)



Source: IRS, *Statistics of Income*, Integrated Business Data

The fastest growth in the pass-through sector came among S corporations. The number of tax returns filed by S corporations rose by 671 percent between 1980 and 2012.

Pass-Through Businesses Can Face Substantial Marginal Tax Rates

While pass-through businesses are not subject to the corporate income tax, they face several substantial taxes on the federal, state, and local levels.

The most significant tax on U.S. pass-through businesses is the federal individual income tax, which is levied at rates ranging up to 39.6 percent. Pass-through businesses pass their income and losses directly to their owners, who include them in their gross income on Form 1040. As a result, the marginal income tax rate on a pass-through business is determined by whatever tax bracket the business's owners fall into.

Table 2.

Federal Individual Income Tax Brackets and Rates, 2017

	Single Filers	Married Joint Filers	Head of Household Filers
10%	$0 to $9,325	$0 to $18,650	$0 to $13,350
15%	$9,325 to $37,950	$18,650 to $75,900	$13,350 to $50,800
25%	$37,950 to $91,900	$75,900 to $153,100	$50,800 to $131,200
28%	$91,900 to $191,650	$153,100 to $233,350	$131,200 to $212,500
33%	$191,650 to $416,700	$233,350 to $416,700	$212,500 to $416,700
35%	$416,700 to $418,400	$416,700 to $470,700	$416,700 to $444,500
39.6%	$418,400+	$470,700+	$444,500+

Source: Kyle Pomerleau, "2017 Tax Brackets," Tax Foundation, http://taxfoundation.org/article/2017-tax-brackets.
Note: Income thresholds refer to dollars of taxable income.

There are two other federal taxes that apply to pass-through businesses: the self-employment tax and the Net Investment Income Tax. Both of these taxes are dedicated toward funding Social Security and Medicare.

The federal self-employment tax applies to sole proprietorship income, as well as partnership income earned by general partners (together, these are referred to as "self-employment income").[11] It is designed to mimic the federal payroll tax system (FICA), which applies at a rate of 15.3 percent for compensation under $127,200 and a rate of 2.9 percent on compensation above that threshold.[12] As such, individuals who make less than $127,000 in wages and self-employment income combined are subject to a 15.3 percent self-employment tax rate, while self-employment income above that threshold is taxed at 2.9 percent.

Since the 2013 tax year, the self-employment tax has also included a 0.9 percent surtax on self-employment income over $200,000 ($250,000 for joint filers), which is designed to mimic the Additional Medicare Tax.[13] Unlike the ordinary self-employment tax, this surtax applies based on household self-employment income, rather than individual self-employment income. All in all, the top self-employment tax rate is 3.8 percent.

The Net Investment Income Tax applies to partnership income earned by limited partners, as well as S corporation income earned by "passive shareholders," as well as several other sources of income.[14] It is levied at a rate of 3.8 percent, on household net investment income over $200,000 ($250,000 for joint filers).

11 26 U.S.C. §1402
12 This threshold is adjusted for inflation. Social Security Administration, "2017 Social Security Changes," https://www.ssa.gov/news/press/factsheets/colafacts2017.pdf.
13 This threshold is not adjusted for inflation.
14 26 U.S.C. §1411. The definition of "passive shareholder" is based on IRS guidelines regarding an owner's level of participation in a business. Income earned by "active shareholders" of S corporations is not subject to self-employment taxes or the Net Investment Income Tax.

Table 3.

Federal Self-Employment and Net Investment Income Taxes for a Single Filer, 2017

Self-Employment Income	Self-Employment Tax Rate	Net Investment Income	Net Investment Income Tax Rate
$0 to $127,200	15.3%	$0 to $127,200	0%
$127,200 to $200,000	2.9%	$127,200 to $200,000	0%
$200,000 +	3.8%	$200,000 +	3.8%

Note: This calculation applies to a single filer who does not earn any wages or salary.

In addition to these federal taxes, pass-through businesses are subject to state and local income taxes. Forty states and the District of Columbia levy state income taxes on pass-through businesses; the highest is California's, with a top rate of 13.3 percent.

After all of these taxes combined, pass-through businesses can face a substantial marginal tax rate on their business income. For instance, a sole proprietor in California can be subject to a marginal tax rate as high as 51.8 percent (see table below).[15]

Table 4.

Top Marginal Tax Rate for a Sole Proprietorship in California, 2017

Top marginal federal income tax	39.6%
Top marginal state income tax	13.3%
Federal self-employment tax	3.8%
Adjustments for the state and local tax deduction, the deductible portion of the self-employment tax, and the Pease limitation	-4.9%
Total	51.8%

Source: Author's calculations

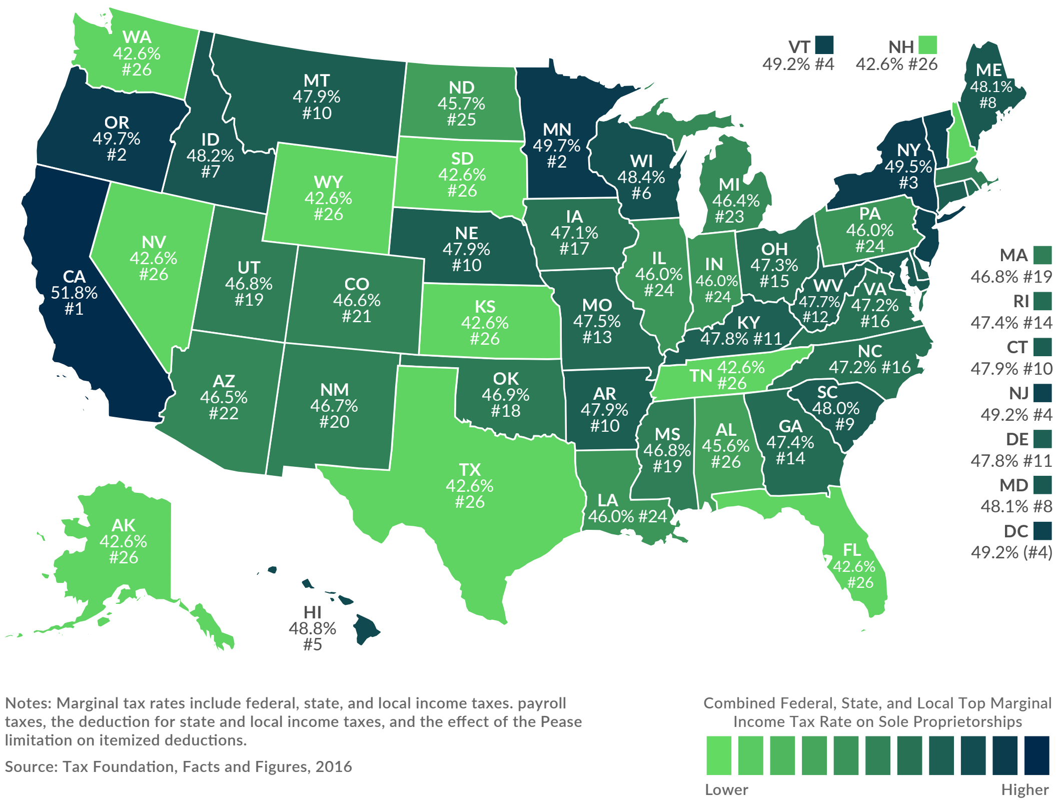
The top marginal tax rate on pass-through business income varies somewhat by state, ranging from 42.6 percent in ten states to 51.8 percent in California (Figure 5). The median state has a top marginal tax rate of 47.2 percent on sole proprietorship income. Weighted by the amount of pass-through business income in each state, the mean top marginal tax rate on sole proprietorships in the United States is 47.1 percent.

15 The marginal tax rate on business income earned by a limited partner or passive S corporation shareholder can be even higher, because a portion of the self-employment tax is deductible from federal taxable income, while no such deduction exists for any portion of the Net Investment Income Tax. In California, in 2017, the top marginal tax rate on a pass-through business income subject to the Net Investment Income Tax is 52.6 percent. On the other hand, the marginal tax rate on income earned by an active S corporation shareholder can be somewhat lower, because the income is neither subject to self-employment taxes nor the Net Investment Income Tax. In 2017, the top marginal tax rate on income earned by an active S corporation shareholder in California is 48.8 percent. See Appendix B, Table 1 for the top marginal tax rates on active and passive S corporation shareholders in each state.

Figure 5.

Pass-through Businesses Face Marginal Tax Rates Close to 50 Percent In Many States

Combined Federal, State, and Local Top Marginal Income Tax Rate on Sole Proprietorships (2016)



Notes: Marginal tax rates include federal, state, and local income taxes. payroll taxes, the deduction for state and local income taxes, and the effect of the Pease limitation on itemized deductions.

Source: Tax Foundation, Facts and Figures, 2016

The Case for the Current Tax Treatment of Pass-Through Business

Because pass-through businesses play such a large role in the U.S. economy, it is likely that the taxation of pass-through businesses will be a central focus of the tax reform debate in 2017 and beyond.

One question that federal lawmakers will face over the coming months is whether to raise or lower the seven individual tax rates on ordinary income (from 10 percent to 39.6 percent), and by how much. Because these rates apply to pass-through business income, they are the most important factor in determining the amount that pass-through businesses pay in federal income taxes.

However, in recent years, there have also been proposals to make more fundamental changes to the system of taxing pass-through businesses. Some scholars have called for taxing certain pass-through businesses as C corporations, meaning that some pass-through businesses would be subject to more than one layer of tax.[16] On the flip side, some

16 For instance, Alexandra Thornton and Brendan Duke, "Ending the Pass-Through Tax Loophole for Big Business," Center for American Progress, 2016, https://www.americanprogress.org/issues/economy/reports/2016/08/10/139261/ending-the-pass-through-tax-loophole-for-big-business/.

policymakers have proposed creating a maximum tax rate for pass-through business income, meaning that some pass-through income would be taxed at lower rates than wages and salaries.[17]

Both of these proposals would be a sharp break from the last century of federal tax policy. Since the enactment of the federal income tax in 1913, income from pass-through businesses has been subject to a single layer of tax, at the same rates that apply to wages, salaries, and most other personal income.[18]

In general, lawmakers should be cautious about making fundamental changes to the tax treatment of pass-through businesses. This is because the current system of taxing pass-through businesses has several important, positive qualities.

The tax treatment of pass-through businesses is largely **neutral**, because pass-through business income is subject to the same income tax rates as most other personal income. In other words, the income tax code neither encourages nor discourages individuals from earning income from pass-through business activity, compared to other economic activities, for the most part.[19]

As a result, the current system of taxing pass-through businesses is also fairly efficient, because it allows individuals to choose whether to participate in pass-through businesses based on the economic merits, rather than based on tax considerations. In general, most economists agree that neutral tax systems are more economically efficient than tax systems that apply higher rates to specific activities.[20]

Finally, the tax treatment of pass-through businesses is relatively **equitable**, because households are taxed on their pass-through business income according to their overall tax bracket. Households with high incomes pay higher marginal income tax rates on their pass-through business income.

All in all, the current system for taxing pass-through businesses is designed well. Recent proposals to change how pass-through businesses are taxed would raise issues regarding neutrality, efficiency, and equity.

Taxing Some Pass-Through Businesses as C Corporations

It is easy to see why requiring some pass-through businesses to be taxed as C corporations would be a misguided approach. The tax treatment of C corporations is highly non-neutral, because the U.S. tax code imposes two layers of tax on corporate income, leading to an

17 For instance, Main Street Fairness Act, H.R. 5076, 114th Cong. (2016).
18 The Revenue Act of 1913 imposed one rate schedule on all personal income, including "the entire net income … of every business, trade, or profession."
19 See Appendix A for an extended discussion of tax neutrality, as applied to the current tax treatment of pass-through businesses.
20 Pigouvian taxes are an exception to this general principle. Joel Slemrod, "Optimal Taxation and Optimal Tax Systems," *The Journal of Economic Perspectives* 4 (1990): 157-178; Louis Kaplow, "On the Undesirability of Commodity Taxation Even When Income Taxation Is Not Optimal," *Journal of Public Economics* 90 (2004): 1235-1250.

especially high top marginal tax rate on income from C corporations.[21] The corporate tax code is also quite inefficient, containing several well-known features that distort business decision-making, such as the bias towards debt financing over equity financing.[22] Finally, it is uncertain whether the corporate income tax even falls primarily on corporate shareholders, or whether it is largely borne by workers, making it difficult to determine whether the tax is equitable.[23]

Proponents of this approach argue that some pass-through businesses are just as large and economically significant as C corporations, and that there is little justification for creating two separate tax regimes for similar types of businesses. There is merit to this line of argument, but instead of forcing pass-throughs into the problematic double tax regime faced by C corporations, lawmakers should work to improve the C corporate tax regime, to move it closer to a single layer of tax at the same rates that apply to wages and salaries.[24] In short, the tax code should treat C corporations more like pass-through businesses, not the other way around.

Creating a Maximum Tax Rate on Pass-Through Business Income

Meanwhile, proposals to create a new, lower rate on pass-through businesses would also raise several concerns. Lawmakers would have to justify why income from pass-through businesses should be subject to a lower tax rate than income from wages and salaries. After all, taxing pass-through business income at a lower rate would make the U.S. tax code *less* neutral, potentially leading individuals to invest in pass-through businesses based on tax considerations, rather than the economic merits.[25] In addition, this policy would only benefit pass-through business owners in the highest tax brackets, creating equity concerns.

Furthermore, a lower tax rate on pass-through business income could create practical difficulties for tax administration. Because such a policy creates strong incentives to categorize as much income as possible as "pass-through business income," it would have the potential to lead to substantial tax avoidance unless accompanied by strong anti-abuse rules.[26] In 2012, Kansas adopted a similar policy – a full exclusion of pass-through

21 See Scott Greenberg, "Corporate Integration: An Important Component of Tax Reform," Tax Foundation, 2016, http://taxfoundation.org/article/corporate-integration-important-component-tax-reform.

22 See Eric Toder and Alan Viard, "Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax," Tax Policy Center, 2014, http://www.taxpolicycenter.org/publications/major-surgery-needed-call-structural-reform-us-corporate-income-tax; Alan Cole, "Fixing the Corporate Income Tax," Tax Foundation, 2016, http://taxfoundation.org/article/fixing-corporate-income-tax.

23 William M. Gentry, "A Review of the Evidence of the Incidence of the Corporate Income Tax," Treasury Department, OTA Paper 101 (2007); Arnold C. Harberger, "Corporation Tax Incidence: What is Known, Unknown, and Unknowable," Conference Paper, 2006, http://www.econ.ucla.edu/harberger/ah-corptax4-06.pdf.

24 This general approach is known as corporate integration. See Scott Greenberg, "Corporate Integration: An Important Component of Tax Reform," Tax Foundation, 2016, http://taxfoundation.org/article/corporate-integration-important-component-tax-reform.

25 For instance, consider the incentives created for households if the maximum tax rate on pass-through business income were 25 percent. We can imagine a household in the 39.6 percent bracket deciding whether to spend $1,000 on consumption or to make an *unprofitable* $1,000 investment in a pass-through business. For the purposes of this example, the investment in question is eligible for full expensing and is expected to return the full $1,000 of principal in one year from now, with no gain (in total, a 0 percent pre-tax return). If the household decides to consume the money immediately, it would be liable for $396 in taxes this year. If the household decides to invest the money in a pass-through business, then the household would be liable for $0 in taxes this year and $250 in taxes next year. Faced with the choice between a $396 tax bill this year and a $250 tax bill next year, the household might choose to undertake an unprofitable investment in a pass-through business, simply to reduce its taxes.

26 One strong anti-abuse rule – stipulating that 70 percent of a pass-through business's net income must be categorized as labor income – has been met with strong opposition from the pass-through business community.

business income – which significantly narrowed the state's tax base, due in part to increased opportunities for tax avoidance.[27]

Conclusion

It is clear that pass-through businesses play a significant role in the U.S. economy. Nine out of every ten companies in the United States are pass-through businesses; combined, they earn over half of all business income, and employ the majority of the private-sector workforce.

Although pass-through businesses are not subject to the federal corporate income tax, they can still face a substantial tax burden from federal, state, and local taxes. In most U.S. states, the top marginal tax rate on pass-through business income exceeds 47 percent.

As the tax reform debate moves forward in 2017, it will be important for policymakers to consider the effects of tax reform proposals on pass-through businesses. Lawmakers should keep in mind that the current system of taxing pass-through businesses is designed well, and they should be cautious about making fundamental changes to it.

27 Scott Drenkard, "Kansas' Pass-through Carve-out: A National Perspective," Tax Foundation, 2016, http://taxfoundation.org/article/kansas-pass-through-carve-out-national-perspective; Mark Robyn, "Not in Kansas Anymore: Income Taxes on Pass-Through Businesses Eliminated," Tax Foundation, 2012, http://taxfoundation.org/article/not-kansas-anymore-income-taxes-pass-through-businesses-eliminated.

Appendix A: The Concept of Tax Neutrality

The concept of tax neutrality can be confusing, and the term is sometimes used in different ways. This paper uses “neutral” to signify investment-consumption neutrality. The tax code is neutral toward a given class of investments if a household’s decision to undertake a marginal investment in that class is unaffected by tax considerations. Put another way, under a neutral tax code, a household would be indifferent between a) spending money on immediate consumption or b) investing the money in an asset that yields a return equal to the household’s discount rate.

To take a very easy example, the current income tax treatment of income from a bond held in a Roth IRA is perfectly neutral, because a household will pay exactly the same amount of federal income tax whether it invests $1,000 in the bond or whether it spends the money on consumption. The household’s decision about whether to consume or invest is entirely unaffected by tax considerations.

To determine whether lowering the tax rate on a given source of personal income would make the U.S. tax code more or less neutral, it is necessary to look at the overall tax treatment of that source of income under current law.

Creating a lower top rate on pass-through business income would likely be a move *away* from tax neutrality. This is because, under the current tax code, the tax treatment of pass-through business investment is already close to neutral. More precisely, the tax treatment of pass-through businesses would be perfectly neutral if pass-through businesses were able to expense the full cost of their capital investments. If expensing applied to all pass-through business investments, then households would be indifferent between consuming their income and investing it in a pass-through business at a normal rate of return.

By contrast, lowering the tax rate on long-term capital gains and qualified dividends would move the tax treatment of equity-financed C corporate investment *closer* to tax neutrality. This is because, under the current U.S. tax code, the tax treatment of corporate stock held in taxable accounts is quite far from neutral. Even with the current, lower rate schedule for long-term capital gains and qualified dividends, the top tax rate on C corporate equity is significantly higher than the top tax rate on wages and salaries, which gives households a significant incentive to consume their income, rather than investing in C corporate stock.

Appendix B: Supplemental Data on Pass-Through Businesses

Appendix Table 1. Combined Top Marginal Tax Rate on Pass-through Businesses by State, 2016

State	Sole Proprietors and General Partners	Active S Corporation Shareholders	Passive S Corporation Shareholders and Limited Partners
Alabama	45.62%	42.64%	46.44%
Alaska	42.58%	39.60%	43.40%
Arizona	46.51%	43.53%	47.33%
Arkansas	47.93%	44.96%	48.76%
California	51.80%	48.82%	52.62%
Colorado	46.56%	43.58%	47.38%
Connecticut	47.93%	44.96%	48.76%
Delaware	47.80%	44.83%	48.63%
District of Columbia	49.17%	46.19%	49.99%
Florida	42.58%	39.60%	43.40%
Georgia	47.39%	44.41%	48.21%
Hawaii	48.75%	45.77%	49.57%
Idaho	48.24%	45.26%	49.06%
Illinois	46.03%	43.05%	46.85%
Indiana	45.97%	42.99%	46.79%
Iowa	47.08%	44.10%	47.90%
Kansas	42.58%	39.60%	43.40%
Kentucky	47.79%	44.81%	48.61%
Louisiana	45.96%	42.98%	46.78%
Maine	48.09%	45.11%	48.91%
Maryland	48.06%	45.08%	48.88%
Massachusetts	46.85%	43.87%	47.67%
Michigan	46.40%	43.42%	47.22%
Minnesota	49.72%	46.74%	50.54%
Mississippi	46.79%	43.81%	47.61%
Missouri	47.46%	44.48%	48.28%
Montana	47.93%	44.96%	48.76%
Nebraska	47.90%	44.92%	48.72%
Nevada	42.58%	39.60%	43.40%
New Hampshire	42.58%	39.60%	43.40%
New Jersey	49.18%	46.21%	50.01%
New Mexico	46.73%	43.75%	47.55%
New York	49.55%	46.57%	50.37%
North Carolina	47.24%	44.26%	48.06%
North Dakota	45.71%	42.73%	46.53%
Ohio	47.25%	44.28%	48.08%
Oklahoma	46.94%	43.96%	47.76%
Oregon	49.75%	46.77%	50.57%

Appendix Table 1, Continued.

State	Sole Proprietors and General Partners	Active S Corporation Shareholders	Passive S Corporation Shareholders and Limited Partners
Pennsylvania	46.04%	43.07%	46.87%
Rhode Island	47.38%	44.41%	48.21%
South Carolina	48.00%	45.02%	48.82%
South Dakota	42.58%	39.60%	43.40%
Tennessee	42.58%	39.60%	43.40%
Texas	42.58%	39.60%	43.40%
Utah	46.79%	43.81%	47.61%
Vermont	49.17%	46.19%	49.99%
Virginia	47.24%	44.26%	48.06%
Washington	42.58%	39.60%	43.40%
West Virginia	47.69%	44.71%	48.51%
Wisconsin	48.39%	45.41%	49.21%
Wyoming	42.58%	39.60%	43.40%
U.S. Average	47.13%	44.15%	47.95%

Note: Many states also apply gross receipts, margin, and franchise taxes to pass-through business income. In addition, some states apply entity-level taxes to S corporations. These are not accounted for in the table above.
Source: Author's calculations

Appendix Table 2. Employment by Business Form and State, 2014

	C Corporations		Pass-Through Businesses (Total)		Sole Proprietorships		Partnerships		S Corporations	
State	Share	Employment	Share	Employment	Share	Employment	Share	Employment	Share	Employment
Alabama	42.1%	728,300	57.9%	1,003,534	20.0%	347,124	11.3%	194,876	26.7%	461,534
Alaska	40.3%	114,853	59.7%	169,812	22.6%	64,441	10.9%	31,000	26.1%	74,371
Arizona	43.6%	1,062,382	56.4%	1,373,429	18.1%	440,937	13.9%	339,144	24.4%	593,348
Arkansas	43.2%	453,349	56.8%	596,660	19.5%	204,844	11.4%	119,401	25.9%	272,415
California	43.1%	6,600,068	56.9%	8,729,622	22.2%	3,406,213	10.4%	1,591,356	24.3%	3,732,053
Colorado	40.5%	969,705	59.5%	1,422,209	18.7%	447,853	13.9%	332,792	26.8%	641,564
Connecticut	43.7%	643,274	56.3%	828,756	20.9%	307,921	16.1%	237,400	19.3%	283,435
Delaware	49.1%	195,702	50.9%	203,009	13.7%	54,655	14.7%	58,509	22.5%	89,845
District of Columbia	43.9%	161,660	56.1%	206,418	17.0%	62,430	22.6%	83,082	16.5%	60,906
Florida	41.2%	3,557,508	58.8%	5,082,343	20.1%	1,739,731	10.4%	901,517	28.3%	2,441,095
Georgia	42.7%	1,707,995	57.3%	2,295,527	21.6%	865,048	10.5%	421,969	25.2%	1,008,510
Hawaii	50.1%	272,212	49.9%	271,486	21.0%	114,377	10.5%	57,021	18.4%	100,088
Idaho	34.6%	202,031	65.4%	381,233	21.0%	122,439	15.4%	89,817	29.0%	168,977
Illinois	44.3%	2,436,213	55.7%	3,068,390	17.5%	963,753	10.6%	581,334	27.7%	1,523,303
Indiana	40.3%	1,056,015	59.7%	1,565,634	16.4%	431,261	12.6%	331,351	30.6%	803,022
Iowa	45.1%	577,921	54.9%	704,151	17.4%	222,456	9.5%	122,062	28.1%	359,633
Kansas	45.1%	539,954	54.9%	656,641	17.9%	214,777	11.8%	140,886	25.2%	300,978
Kentucky	43.6%	694,931	56.4%	897,393	19.2%	305,141	12.2%	194,488	25.0%	397,764
Louisiana	38.3%	710,963	61.7%	1,143,685	20.5%	380,761	14.9%	276,817	26.2%	486,107
Maine	35.2%	174,319	64.8%	320,459	24.3%	120,135	9.6%	47,503	30.9%	152,821
Maryland	40.8%	947,363	59.2%	1,374,460	21.2%	492,043	11.4%	265,562	26.6%	616,855
Massachusetts	45.0%	1,307,633	55.0%	1,595,143	18.5%	537,166	10.5%	304,834	25.9%	753,143
Michigan	42.5%	1,551,151	57.5%	2,101,314	16.4%	599,519	13.0%	474,439	28.1%	1,027,356
Minnesota	42.3%	1,042,923	57.7%	1,424,426	17.1%	421,802	9.4%	231,374	31.3%	771,250
Mississippi	41.9%	412,954	58.1%	572,713	23.4%	230,761	11.9%	117,517	22.8%	224,435
Missouri	44.7%	1,075,740	55.3%	1,333,424	18.6%	448,452	11.1%	266,543	25.7%	618,429
Montana	31.4%	119,781	68.6%	262,148	22.9%	87,424	12.0%	45,757	33.8%	128,967
Nebraska	40.7%	345,809	59.3%	504,854	16.2%	137,454	9.4%	80,119	33.8%	287,281
Nevada	44.4%	550,067	55.6%	688,633	17.5%	216,355	15.6%	192,972	22.5%	279,306
New Hampshire	41.0%	233,811	59.0%	335,830	21.4%	121,836	11.6%	66,017	26.0%	147,977
New Jersey	41.7%	1,561,231	58.3%	2,181,255	18.3%	686,265	15.8%	593,047	24.1%	901,943
New Mexico	39.8%	254,204	60.2%	384,459	21.1%	135,060	13.9%	88,465	25.2%	160,934
New York	39.4%	3,101,935	60.6%	4,762,703	21.0%	1,648,990	13.8%	1,085,864	25.8%	2,027,849
North Carolina	44.7%	1,682,836	55.3%	2,084,595	19.6%	739,213	9.8%	370,051	25.9%	975,331
North Dakota	38.0%	127,520	62.0%	208,473	17.1%	57,442	11.1%	37,157	33.9%	113,874
Ohio	44.5%	2,074,729	55.5%	2,590,348	18.0%	841,177	11.8%	548,201	25.7%	1,200,970
Oklahoma	40.4%	589,800	59.6%	868,975	20.1%	293,582	14.3%	208,895	25.1%	366,498
Oregon	40.0%	594,809	60.0%	893,557	20.0%	297,526	12.1%	180,411	27.9%	415,620
Pennsylvania	43.2%	2,167,764	56.8%	2,855,287	18.2%	913,043	11.3%	565,105	27.4%	1,377,139
Rhode Island	37.3%	151,488	62.7%	254,172	18.8%	76,184	9.6%	38,964	34.3%	139,024
South Carolina	43.6%	766,549	56.4%	989,824	19.4%	341,492	11.3%	198,321	25.6%	450,011
South Dakota	33.7%	112,436	66.3%	221,168	20.2%	67,386	12.2%	40,623	33.9%	113,159
Tennessee	46.8%	1,224,105	53.2%	1,391,440	21.9%	573,331	16.4%	429,666	14.9%	388,443
Texas	44.4%	4,954,767	55.6%	6,197,271	21.1%	2,357,804	15.4%	1,717,186	19.0%	2,122,281
Utah	41.0%	502,640	59.0%	722,886	15.3%	187,055	15.7%	191,879	28.1%	343,952
Vermont	34.8%	90,263	65.2%	168,826	27.2%	70,585	9.3%	24,212	28.6%	74,029
Virginia	44.5%	1,477,090	55.5%	1,840,105	17.9%	593,351	11.1%	367,790	26.5%	878,964
Washington	43.0%	1,109,811	57.0%	1,470,607	18.5%	477,960	11.6%	298,092	26.9%	694,555

Appendix Table 2, Employment by Business Form and State, 2014, Continued.

State	C Corporations		Pass-Through Businesses (Total)		Sole Proprietorships		Partnerships		S Corporations	
	Share	Employment	Share	Employment	Share	Employment	Share	Employment	Share	Employment
West Virginia	46.2%	258,872	53.8%	301,326	19.5%	109,046	12.7%	71,038	21.6%	121,242
Wisconsin	42.1%	998,866	57.9%	1,374,710	16.4%	390,412	10.1%	238,566	31.4%	745,732
Wyoming	36.9%	88,775	63.1%	152,126	19.0%	45,798	13.8%	33,157	30.4%	73,171

Source: Author's calculations based on Census County Business Patterns (2014) and Non-Employer Statistics (2014)
Note: Due to data constraints, some employees may be counted more than once

Appendix Table 3. Payroll by Business Form and State, 2014 (Thousands of Dollars)

State	C Corporations		Pass-Through Businesses (Total)		Sole Proprietorships		Partnerships		S Corporations	
	Share	Payroll	Share	Payroll	Share	Payroll	Share	Payroll	Share	Payroll
Alabama	58.6%	$32,631,814	41.4%	$23,015,136	2.6%	$1,459,438	9.9%	$5,511,228	28.8%	$16,044,470
Alaska	59.2%	$7,637,024	40.8%	$5,257,502	3.8%	$484,445	9.9%	$1,280,611	27.1%	$3,492,446
Arizona	63.8%	$52,260,677	36.2%	$29,680,395	1.6%	$1,302,637	11.2%	$9,164,882	23.4%	$19,212,876
Arkansas	62.9%	$20,202,410	37.1%	$11,918,363	1.6%	$511,920	9.9%	$3,188,498	25.6%	$8,217,945
California	65.7%	$435,124,913	34.3%	$227,622,633	2.4%	$16,194,868	10.0%	$66,006,649	21.9%	$145,421,116
Colorado	59.9%	$54,783,323	40.1%	$36,731,115	1.8%	$1,618,946	12.4%	$11,349,327	26.0%	$23,762,842
Connecticut	65.7%	$47,941,077	34.3%	$25,035,180	2.6%	$1,927,014	14.0%	$10,205,948	17.7%	$12,902,218
Delaware	64.5%	$11,073,135	35.5%	$6,096,836	1.1%	$194,800	16.6%	$2,844,762	17.8%	$3,057,274
District of Columbia	55.9%	$12,963,513	44.1%	$10,232,113	2.9%	$683,330	27.1%	$6,295,162	14.0%	$3,253,621
Florida	58.8%	$155,383,422	41.2%	$108,958,895	1.4%	$3,764,598	10.7%	$28,414,641	29.0%	$76,779,656
Georgia	64.4%	$89,275,115	35.6%	$49,310,768	1.7%	$2,423,741	10.3%	$14,292,240	23.5%	$32,594,787
Hawaii	68.3%	$11,208,637	31.7%	$5,208,993	3.0%	$500,668	10.2%	$1,676,711	18.5%	$3,031,614
Idaho	51.9%	$8,457,560	48.1%	$7,845,617	2.2%	$362,896	14.8%	$2,413,627	31.1%	$5,069,094
Illinois	61.1%	$139,762,795	38.9%	$88,853,444	2.3%	$5,307,663	11.8%	$26,869,467	24.8%	$56,676,314
Indiana	56.9%	$50,834,294	43.1%	$38,508,980	2.0%	$1,769,260	11.6%	$10,359,262	29.5%	$26,380,458
Iowa	61.9%	$26,181,269	38.1%	$16,143,725	2.2%	$914,259	7.4%	$3,118,946	28.6%	$12,110,520
Kansas	64.0%	$26,693,904	36.0%	$15,021,413	2.0%	$839,361	9.4%	$3,938,698	24.6%	$10,243,354
Kentucky	61.6%	$30,385,970	38.4%	$18,910,733	2.7%	$1,339,468	10.8%	$5,345,089	24.8%	$12,226,176
Louisiana	54.4%	$34,874,552	45.6%	$29,174,735	2.4%	$1,568,844	14.5%	$9,306,667	28.6%	$18,299,224
Maine	54.6%	$7,913,513	45.4%	$6,574,384	3.2%	$459,647	8.0%	$1,160,036	34.2%	$4,954,701
Maryland	58.6%	$53,694,477	41.4%	$37,864,474	2.3%	$2,135,028	10.7%	$9,786,234	28.3%	$25,943,212
Massachusetts	65.2%	$95,027,968	34.8%	$50,830,972	2.0%	$2,864,988	10.4%	$15,226,208	22.4%	$32,739,776
Michigan	60.4%	$82,187,914	39.6%	$53,863,357	2.1%	$2,851,981	11.4%	$15,490,838	26.1%	$35,520,538
Minnesota	62.4%	$63,367,464	37.6%	$38,122,330	2.1%	$2,169,089	8.0%	$8,146,844	27.4%	$27,806,397
Mississippi	61.6%	$16,433,240	38.4%	$10,245,589	3.1%	$818,047	11.0%	$2,946,478	24.3%	$6,481,064
Missouri	63.4%	$52,588,988	36.6%	$30,296,714	2.0%	$1,659,881	9.6%	$7,935,405	25.0%	$20,701,428
Montana	49.9%	$4,982,716	50.1%	$5,008,713	2.8%	$279,588	9.5%	$949,832	37.8%	$3,779,293
Nebraska	56.1%	$15,874,211	43.9%	$12,400,990	2.0%	$551,704	7.1%	$2,007,085	34.8%	$9,842,201
Nevada	58.0%	$22,928,731	42.0%	$16,617,427	3.7%	$1,480,749	14.5%	$5,735,033	23.8%	$9,401,645
New Hampshire	59.3%	$12,346,173	40.7%	$8,467,344	3.2%	$676,138	8.5%	$1,764,928	29.0%	$6,026,278
New Jersey	63.3%	$110,920,819	36.7%	$64,209,870	2.1%	$3,722,862	11.5%	$20,220,349	23.0%	$40,266,659
New Mexico	55.5%	$10,846,157	44.5%	$8,693,755	2.9%	$562,595	14.6%	$2,853,621	27.0%	$5,277,539
New York	59.3%	$231,214,446	40.7%	$158,727,002	2.1%	$8,069,840	17.0%	$66,187,304	21.7%	$84,469,858
North Carolina	64.4%	$79,615,843	35.6%	$44,087,993	2.0%	$2,525,988	8.8%	$10,878,306	24.8%	$30,683,699

Appendix Table 3, Payroll by Business Form and State, 2014 (Thousands of Dollars), Continued.

	C Corporations		Pass-Through Businesses (Total)		Sole Proprietorships		Partnerships		S Corporations	
State	Share	Payroll	Share	Payroll	Share	Payroll	Share	Payroll	Share	Payroll
North Dakota	54.5%	$6,798,312	45.5%	$5,683,718	2.5%	$315,781	8.4%	$1,045,033	34.6%	$4,322,904
Ohio	62.8%	$104,685,977	37.2%	$62,067,790	2.2%	$3,669,635	10.2%	$17,065,741	24.8%	$41,332,414
Oklahoma	58.5%	$28,456,996	41.5%	$20,226,704	2.5%	$1,213,867	13.8%	$6,694,581	25.3%	$12,318,256
Oregon	62.0%	$32,230,171	38.0%	$19,746,720	2.2%	$1,143,999	8.8%	$4,569,402	27.0%	$14,033,319
Pennsylvania	61.0%	$119,273,155	39.0%	$76,310,045	2.6%	$5,141,445	9.7%	$19,022,565	26.7%	$52,146,035
Rhode Island	54.1%	$7,595,709	45.9%	$6,442,649	1.9%	$269,624	7.8%	$1,096,469	36.2%	$5,076,556
South Carolina	62.2%	$32,959,570	37.8%	$20,044,068	2.3%	$1,229,724	10.3%	$5,473,986	25.2%	$13,340,358
South Dakota	47.6%	$4,453,501	52.4%	$4,895,153	2.7%	$254,262	11.1%	$1,037,056	38.5%	$3,603,835
Tennessee	66.1%	$57,068,980	33.9%	$29,217,566	3.2%	$2,766,662	13.8%	$11,934,583	16.8%	$14,516,321
Texas	63.9%	$275,691,057	36.1%	$155,608,825	2.6%	$11,088,812	15.7%	$67,532,894	17.9%	$76,987,119
Utah	59.5%	$24,072,750	40.5%	$16,394,183	1.2%	$470,618	11.8%	$4,768,138	27.6%	$11,155,427
Vermont	55.4%	$4,312,140	44.6%	$3,477,016	3.6%	$278,583	7.1%	$555,098	33.9%	$2,643,335
Virginia	61.7%	$84,383,879	38.3%	$52,308,628	2.1%	$2,881,011	10.1%	$13,823,850	26.0%	$35,603,767
Washington	64.6%	$73,600,628	35.4%	$40,325,938	2.6%	$2,913,804	8.9%	$10,173,384	23.9%	$27,238,750
West Virginia	65.0%	$11,527,024	35.0%	$6,197,835	3.6%	$632,879	10.9%	$1,939,469	20.5%	$3,625,487
Wisconsin	59.2%	$50,752,037	40.8%	$34,952,990	2.2%	$1,894,760	7.8%	$6,650,335	30.8%	$26,407,895
Wyoming	54.6%	$4,783,912	45.4%	$3,974,838	2.2%	$192,048	11.2%	$980,486	32.0%	$2,802,304

Source: Author's calculations based on Census County Business Patterns (2014)
Note: Does not include non-employer firms