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Wealthy Americans and Business Activity

Helped by Tax Cuts, Businesses Producing Lion's Share of Tax Revenue

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Are high-income[1] taxpayers entrepreneurs and business owners, or are they simply well-paid individuals with trivial business activity on the side which tax cuts have no effect on? This has been a hotly contested question since the cuts in the top marginal tax rates were first set in motion in 2001.

The Bush Treasury says that recent cuts in individual tax rates help businesses too, citing as evidence that roughly three out of four high-income taxpayers' returns show business activity, that is, income from sole proprietorships, partnerships, farms or S-Corporations. Such businesses range in size from small sole proprietorships to multinational S-Corporations.

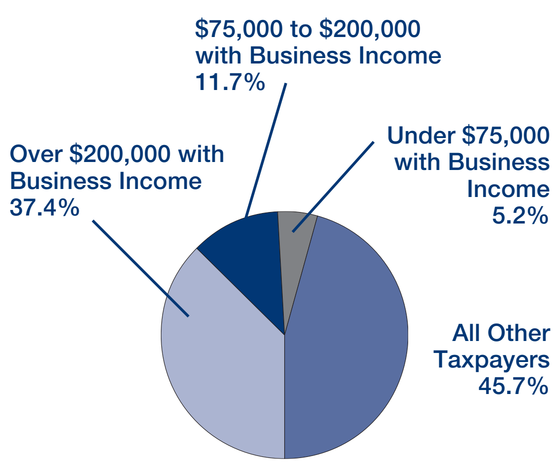
On the other side of the debate, scholars such as William G. Gale, (*Tax Notes,* April 26, "Small Businesses and Marginal Income Tax Rates") argue that the top marginal tax rate cuts did little for business owners because (1) only a fraction of small business owners earn enough to pay the top tax rates, and (2) those high-income taxpayers who are business owners receive only one-third of their overall adjusted gross income from business income.

Both sides of the debate define "business owner" broadly to include everyone who reports business income on Schedules C, E and F of their individual income tax return, but even still, it is difficult to reconcile the two differing interpretations of the data. Publicly available IRS data are not detailed enough to reveal how business owners and/or high-income taxpayers structure their affairs, especially when it comes to tracing the income of pass-through business entities such as S-Corporations.

For instance, the IRS's published data

[1] This study defines "high-income taxpayer" as one who is the top 1 percent of taxpayers (AGI over 317,000 in 2004) and, as a consequence, would be subjected to either the 33 or 35 percent federal individual income tax bracket.

Figure 1
Business Owners Pay 55 Percent of Income Taxes, Calendar Year 2004



Source: Tax Foundation Individual Tax Model based on IRS and Census data.

Table 1
As Incomes Rise, So Does the Likelihood of Business Income, Calendar Year 2004

Income Range	Percentage of Taxpayers With Business Income
$317,000 to $499,999	68.2%
$500,000 to $999,999	76.6%
$1 million and above	82.7%
Average of Taxpayers in the Top 1 Percent of Earners	73.7%

Source: Tax Foundation Individual Tax Model based on IRS and Census data.

obscures the fact that roughly 87 percent of high-income tax returns represent married couples, and that any business income or wages could come from either or both spouses. Thus, the lack of detailed data not only makes it difficult to accurately judge the total number of high-income business owners, but it magnifies the difficulty of determining how these couples have arranged their finances between salary income versus business income.

The stakes of this debate are high because there has been an explosion of businesses filing through the individual income tax code over the past two decades. Between 1980 and 2002, for example, the total number of sole proprietorships, partnerships, farms, and S-Corporations nearly doubled, from 13.3 million in 1980 to 25.5 million in 2002. S-Corps alone grew 500 percent, from 545,389 in 1980, to roughly 3.2 million in 2002, and now far exceed the number of conventional C-Corporations. This year, the IRS estimates that 57 percent of all corporate tax returns will be S-Corporation returns.

Fortunately, the Tax Foundation's Individual Tax Model and Matched IRS/Census Database permit us to take a deeper look at this complex issue and project to the current year how much and what type of business activity is going on at the high end of the income spectrum.

Business Activity Rises With Income

A significant finding is that an extraordinarily high proportion of high-income taxpayers have some form of business income and that as their incomes rise, so too does the likelihood that they have business activity. Tax Foundation estimates show that overall, about 74 percent of the wealthiest one percent of taxpayers have business activity (see Table 1). Of those taxpayers with incomes between $317,000 and $499,999 per year, 68 percent have business income. But for those with incomes between $500,000 and $999,999, nearly 77 percent file returns with business activity. And for taxpayers with incomes above $1 million per year, nearly 83 percent have business income.

This business activity comes in three basic forms: Schedule C (sole proprietorship); Schedule E (S-Corporations, royalties, and partnerships); and Schedule F (farm income). The most common of these are Schedule E with nearly two-thirds (62.7 percent) of high-income taxpayers having Schedule E income. Although published IRS tax return data provides little detail on how these taxpayers structure their business income, it is likely that much of this income is generated by S-Corporations. By contrast, 24.9 percent of those in the top one percent of earners have Schedule C (sole proprietorship) income — although 48 percent of these high-income taxpayers have both Schedule C and Schedule E. An even smaller share, 8.9 percent, has farm income.

Business Owners Pay Lion's Share of Income Taxes

Critics of the top rate cut assert that only a small percentage of small businesses earn enough to reach the top brackets.

"Less than 3 percent [of business owners] face rates of 33 percent and above, and only 1.3 percent are in the top bracket," said Gale.

However, those percentages would not be so low if Gale's report did not include the 21.8 percent of all business owners who are in the "zero statutory income tax bracket." These are firms with no income tax liability, and are

Table 2
What are the Sources of Income for High-Income Taxpayers?
Calendar Year 2004

Source of Income for Taxpayers in the Top 1% of Earners	Share of Total AGI
Salaries and Wages	37.1%
Schedule E	20.6%
Capital Gains	18.1%
Taxable Interest	5.0%
Schedule F	4.1%
Dividends	3.1%
Schedule C	2.8%

Source: Tax Foundation Individual Tax Model based on IRS and Census data.

Table 3
Business Losses are Just as Common as Business Profits for High-Income Taxpayers
Calendar Year 2004

Schedule C, E and F Income as a Percentage of AGI	Percentage of Taxpayers in the Top 1% of Earners With this Share of Business Income
-0.01% to -100%	20.08%
0.01% to 4.99%	20.82%
5% to 14.99%	11.02%
15% to 24.99%	5.62%
25% to 49.99%	10.94%
50% to 74.99%	12.60%
75% to 99.99%	15.22%
100% and above	3.71%

Source: Tax Foundation Individual Tax Model based on IRS and Census data.

therefore properly excluded from a discussion of the impact of income tax cuts. Restricting the data analyzed to those returns with a positive liability would raise the percentage of firms exposed to the top rates significantly.

But even more important to the economy than the number or percentage of business owners whose tax cut enables them to hire more people is the amount of tax payments they make or are saved from making. It is these amounts that will determine the economic boost of the rate cut.

Individually owned business pay the lion's share of all individual income tax collections. We estimate that in 2004, business owners — specifically those with a positive tax liability — will pay 54.3 percent of all individual income taxes in 2004. Remarkably, 37.4 percent of all income tax collections will come from business owners earning over $200,000 — roughly the wealthiest 2 percent of taxpayers. Of the total amount of income taxes collected from business owners, 69 percent will come from these upper-income taxpayers (see Figure 1). Since taxpayers with business income are shouldering such a disproportionate share of the tax burden, it is only logical that tax cuts in the top marginal tax

Table 4
In What Occupations are High-Income Taxpayers Engaged?
Calendar Year 2004

Occupational Code	Percentage of Taxpayers in the Top 1% of Earners in Each Occupational Category [or Subcategory]	
No Category or Retired		14.3%
Executive, administrative & managerial		31.5%
Managers and Administrators	[18.2%]	
Marketing, Advertising, Public Relations	[1.5%]	
Financial Officers	[1.9%]	
Accountants and Auditors	[1.5%]	
Professional Specialty		27.7%
Physicians	[7.3%]	
Computer Systems Analysts/Scientists	[1.8%]	
Lawyers and Judges	[4.1%]	
Technicians & Related Support		2.7%
Sales		12.9%
Supervisors and Proprietors	[3.2%]	
Insurance Sales	[1.1%]	
Securities and Financial Services	[2.7%]	
Real Estate Sales	[1.8%]	
Sales: mining, manufacturing, wholesale	[2.2%]	
Administrative Support		2.4%
Other service (pest control, food service)		0.9%
Precision production and crafts		3.2%
Machine operators and assemblers		1.1%
Transportation		0.5%
Farming, forestry & fishing		2.0%
Farmers	[1.5%]	

Source: Tax Foundation Individual Tax Model based on IRS and Census data.

Table 5
In What Industries are High-Income Taxpayers Engaged?
Calendar Year 2004

Industry Code	Percentage of Taxpayers in the Top 1% of Earners in Each Industrial Category [or Subcategory]	
No Category or Retired		14.3%
Agriculture		2.4%
Agricultural Production, Livestock	[1.1%]	
Mining		0.5%
Construction manufacturing		4.9%
Manufacturing-durable goods		8.1%
Printing and publishing, except newspapers	[1.0%]	
Manufacturing-nondurable goods		3.2%
Transportation		2.6%
Communications		1.8%
Radio, Television, Cable	[1.0%]	
Utilities and sanitary services		1.1%
Wholesale trade		4.1%
Retail trade		5.0%
Eating and Drinking Places	[1.0%]	
Finance, insurance and real estate		13.2%
Banking	[1.6%]	
Credit Agencies	[1.4%]	
Securities, Brokerage, Investment Companies	[4.1%]	
Insurance	[1.8%]	
Real Estate	[4.2%]	
Private household miscellaneous		0.2%
Business and repair		6.0%
Computer and Data Processing Services	[2.6%]	
Business Services	[1.6%]	
Personal services (hotels, funeral services)		0.8%
Entertainment professional		1.1%
Hospital		4.2%
Medical, except hospital		6.8%
Offices of Physicians	[4.4%]	
Offices of Dentists	[1.2%]	
Educational Services		6.9%
Social services		0.3%
Other professional		9.2%
Legal Services	[3.2%]	
Accounting and Auditing	[1.1%]	
Management and Public Relations	[2.2%]	
Forestry and fisheries		0.2%
Public administration		3.0%
Justice, Public Order, Safety	[1.4%]	

Source: Tax Foundation Individual Tax Model based on IRS and Census data.

rates will disproportionately benefit them. Common sense tells us that tax cuts can only aid those who pay taxes in the first place.

Business Activity and Income Shifting

Table 2 shows the major sources of income for taxpayers in the top one percent. Salaries and wages are by far the largest share of their aggregate income at 37 percent. Total business income (schedules C, E, and F) is the next largest share of their aggregate income at roughly 28 percent, while capital gains income comprises roughly 18 percent.

To critics, the fact that business activity comprises less than one-third of the total income for high-income taxpayers is proof that the top marginal tax rate cuts did not help many businesses. However, this line of reasoning is flawed for several reasons.

First, it is unrealistic to think that business owners would rely solely on profit disbursements from their business to pay their families' bills. Instead, they would pay themselves a healthy salary first, then pocket any residual profits at the end of the year, leaving them with a majority of their income in salaries and wages despite their business ownership.

Secondly, IRS rules require S-Corporations to pay employee-shareholders a "reasonable salary" in order to prevent owners from avoiding FICA and Medicare taxes by taking all of their compensation in dividends, which are not subject to self-employment taxes.

Thirdly, for most business owners — especially small business owners — the business is their principal form of savings. Hence, profits tend to be invested back into the firm. Indeed, business owners may have to leave profits in their businesses in order to maintain a credit or bond rating. So after paying salaries, expenses, and reinvesting any retained earnings, these businesses do not always have any profits left to distribute to the owners.

Fourthly, with the uncertainties of the economy and business profitability, it makes sense that owners of start-ups or firms with operating losses would pay themselves a salary first, before collecting any residual profits. Table 3 shows the amount of business income that wealthy taxpayers claim as a percentage of their total adjusted gross income. The table shows that 20 percent of high-income taxpayers have business losses and another 20 percent receive less than 5 percent of their total compensation from business income.

But the simple fact is that the salary that an owner pays himself is just as much "business income" as is the distribution of profits he may pocket at the end of the year. So while on paper it appears that only one-third of the overall income of high-income taxpayers comes from "business income," the real share of business income to AGI could be nearly 65 percent if we were to combine their salaries and wages with their Schedule C, E, or F income.

This figure does not include other ways in which a business owner may take profits out of the firm. For example, an entrepreneur who capitalized his business with a loan or a private stock sale may receive regular interest or dividends in return. As Table 2 shows, taxable interest and dividends account for roughly 8 percent of the overall income for high-income taxpayers. Thus, the real share of AGI comprised by business income could be as high as 73 percent. While it is possible that this interest and dividend income is derived from traditional investments, some of this money is certainly "business income" being shifted into interest or dividend income.

Business Occupations and Industry Sectors

Another way to gauge the economic impact of these high-income business owners is to look at how they classify their occupations or industries on a Census survey. Table 4 lists some of the major occupational categories, and Table 5 lists their various industries. Overall, these tables reveal that high-income business owners are involved in nearly all occupations and industries of the U.S. economy.

Conclusion

The data clearly shows that a large proportion of high-income taxpayers are engaged in some form of business activity. Moreover, the percentage of high-income taxpayers with business activity rises with their incomes. They also pay the vast majority of income taxes paid by businesses that file through the individual income tax code.

Measuring business income as a percentage of AGI yields an erroneous view of business activity since many business owners take their "business income" in the form of regular salaries or, perhaps, in the form of interest and dividends. Finally, we find that these high-income taxpayers are engaged in a wide variety of business occupations and industries throughout the economy. The only conclusion from these findings is that lowering the top marginal income tax rates did indeed benefit many highly taxed business owners and the U.S. economy.

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