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Sources of Personal Income

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Key Findings

- Taxpayers reported $9.2 trillion of total income on their 2012 tax returns, a substantial increase from the previous year's $8.4 trillion.
- 68 percent ($6.3 trillion) of total income reported on individual income tax returns is in wages and salaries, and about 83% of all tax filers report wage income.
- In order to substantially increase revenues, policymakers generally have to look to labor compensation as the main tax base, simply because of its sheer scale.
- Pensions and retirement accounts make up a substantial portion of capital income, but are frequently forgotten in analysis of income data. The middle-class, in fact, has a colossal equity stake in American capital through such accounts.
- Business income is also a large feature of the individual tax code. Some businesses, like S-corporations, sole proprietorships, or partnerships, file their taxes through the individual tax code.
- Capital gains and dividends accounted for about $883 billion in income in 2012, which is roughly equal to income from business ($839 billion) and retirement accounts ($843 billion).

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Introduction

The individual income tax is the federal government's largest source of revenue. Over 144 million individual income tax returns[1] were filed for the year 2012, and in each of these filings a taxpayer added up his or her income in order to report it to the Internal Revenue Service (IRS.) The way that the IRS individual income tax form (Form 1040) is structured, one first lists all sources of income on the front side of the form, adding these up to reach "total income." After this, the tax return moves on to deductions and credits.

This report will focus on sources of total income in 2012, which was reported as $9.2 trillion.[2] It will break down that income into the component parts, reported on lines 7 to 22 of the 2012 Form 1040. Going through the amounts of income reported for each of these categories is a useful and instructive exercise for two reasons: it can help us understand the composition of the government's revenue base, and it can help us understand how the rewards to economic activity are distributed in the U.S. economy.[3]

In going through this data, we will see that most personal income in the United States comes from labor. Sources of capital income are substantial, but smaller, and divided into many subcategories. Not all of these types of income have similar tax treatment, or even similar methods of accounting, and as a result, studies of income data count capital income poorly.

Table 1. Top Ten Sources of Total Income on U.S. Individual Income Tax Returns, 2012

Income Type	Amount (billions)
Salaries and Wages	$6,301
Capital Gains Less Losses	$623
Taxable Pensions and Annuities	$612
Partnerships and S-Corporation Net Income	$535
Business Net Income	$304
Dividends	$260
Taxable IRA Distributions	$231
Taxable Social Security Benefits	$224
Taxable Interest (a)	$112
Unemployment Compensation	$71

(a) Tax-free interest, such as interest on municipal bonds, adds another $71 billion.
Source: IRS SOI Table 1.3

1 IRS Statistics of Income Tax Stats, Table 1.3, http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax-Returns-Publication-1304-(Complete-Report). This table will be the source for all data in this report.

2 *Id.*

3 There are limitations on using data from the 1040 to understand the nature of income in the U.S. economy. Not all economic activity finds its way to personal income tax forms—particularly, employer-provided health insurance and returns to owner-occupied housing are both substantial components of economic output that do not appear on income tax returns. As broad economic aggregates, though, the categories of income established on the 1040 are still useful and instructive.

Wages and Salaries Make Up 68 Percent of Total Income at $6.3 Trillion

For most tax filers in the U.S., the largest number on the 1040 comes on line 7, the very first line pertaining to income. It is on this line that taxpayers mark wages, salaries, tips, and other compensation for their work. Most Americans get that number from their W-2 forms, supplied by their employers. In total, 120 million tax filers reported $6.3 trillion in wage income, or 68.2 percent of all total income.[4]

Most Americans report labor income, and most of their income comes from labor. This should not be a surprise; the U.S. is a nation of workers, and most of its economy is labor compensation. Any meaningful attempt to raise revenue through the income tax will almost necessarily include wages and salary in the base, just by virtue of the arithmetic. One cannot raise much income tax revenue by excluding 68 percent of income.

The amounts reported on the 1040 reflect most, but not all, labor compensation. Firms also pay for employee health benefits, and make contributions to social security. Although neither of these is touched by the personal income tax, the IRS has a hand in both; the Patient Protection and Affordable Care Act levies a “Cadillac Tax” on some health plans, and the IRS administers the payroll tax through employer withholding.

Business Income Accounts for $839 Billion of Personal Income

In the United States, the dominant tax filing structure for firms is to file taxes as “pass-through” entities, so labeled because their income immediately passes through to the individual owners for tax purposes. 95 percent of businesses use this structure, and their income shows up on schedules C, E, and F on individual tax returns. While some pass-throughs are quite large, the majority of such businesses are sole-proprietorships, fully owned by a single individual. Pass-throughs employ the majority of the private-sector workforce in the U.S., and account for the majority of all business income.[5] Partnerships and S-corporations accounted for $535 billion of net income in 2012, and individuals reported an additional $304 billion of business income.[6]

Capital Gains and Dividends Are the Source of $883 Billion of Personal Income

Certain kinds of income are taxed at what appear to be lower rates—specifically, qualified capital gains and dividends. They draw a lot of scrutiny because of this apparent preference, and also because they fit into the larger debate about income inequality.

4 IRS SOI Table 1.3, above.

5 Kyle Pomerleau, *An Overview of Pass-through Businesses in the United States*, Tax Foundation Special Report No. 227 (Jan. 21, 2015), http://taxfoundation.org/article/overview-pass-through-businesses-united-states.

6 IRS SOI Table 1.3, above.

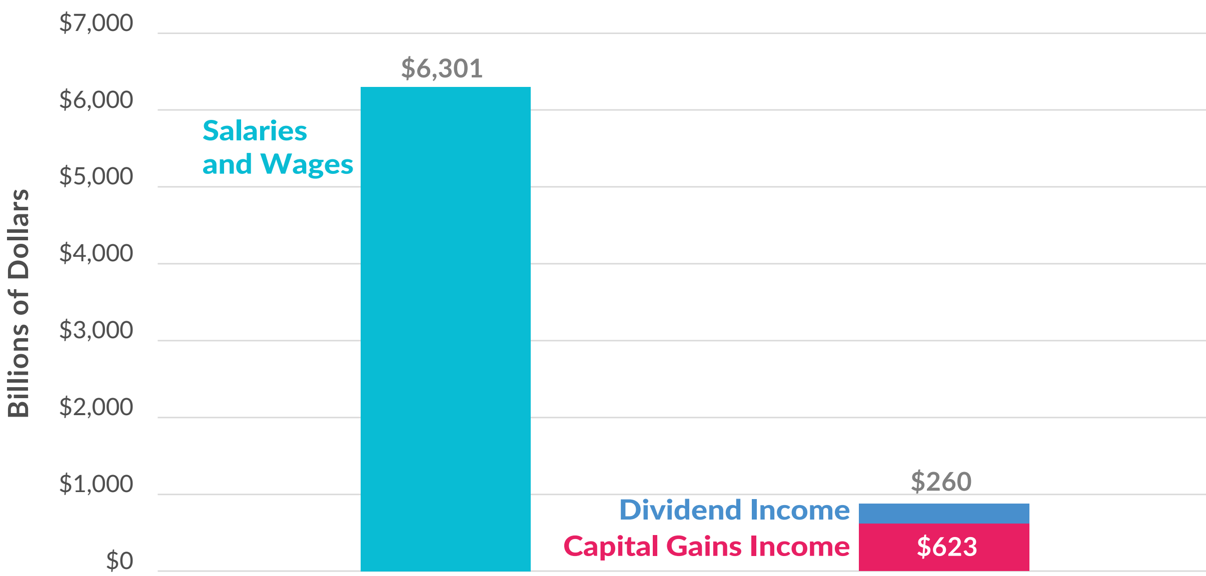
Rhetoric about corporate income is often expressed in terms of "record profits," giving the impression that a large portion of income in the country goes to the owners of corporations. The returns to corporate equity, as found on individual income tax returns, are substantial, but much more modest than the rhetoric might imply. Taxpayers reported $260 billion of taxable dividends in 2012, and $623 billion of net capital gains, only some of which come from sale of corporate stock.[7] While these amounts certainly matter, they are not very effective sources for tax revenue.

The amount reported in capital gains and dividends belies several popular notions about capital income: first, the notion that corporations are divvying their revenues towards owners, not workers, or the idea that there is a large idle capitalist class that makes its money off of corporate ownership without work. In truth, taxable labor compensation greatly exceeds taxable investment income (Figure 1). It also contradicts the notion that increasing taxes on investment income would have a substantial effect on the U.S. budget deficit.

Just as some labor compensation is not taxable, some investment income is not taxable: for example, those earned by nonprofit university endowments. Additionally, a lot of dividend and capital gains income accrues to pension funds and other worker retirement plans, and taxed when the plan distributes the income. Neither of these situations resembles any sort of hegemony of ownership interests over labor interests.

Figure 1: Wage Income Greatly Exceeds Investment Income

Taxable Wage and Dividend Income in the United States, 2012 (Billions of Dollars)



Source: IRS SOI Table 1.3

7 *Id.*

Capital gains and dividend taxes have several problems: despite superficially-preferential rates, they are structured improperly in a way that creates a bias against saving, harms economic growth, and hurts revenue. [8] It would be far better to tax capital income at ordinary rates, but allow individuals to deduct their contributions to investment accounts—in other words, all saving should have the treatment that Individual Retirement Accounts currently have.

Pensions are the Middle-Class's Source of Capital Income

In 2012, taxpayers reported a total of $612 billion from pensions and annuities, and another $231 billion in Individual Retirement Account (IRA) distributions.[9] America's system of retirement accounts, while overly complex, is taxed in a neutral way that removes the bias against saving. Furthermore, it actually works pretty well at providing people income in their retirement. Notably, the income from retirement accounts is similar in scale to the capital gains and dividend income reported outside of retirement accounts; both are between $800 and $900 billion.

It's often hard to keep track of capital income in retirement accounts, especially because it doesn't show up on IRS forms until it is distributed. Economists often struggle with categorizing it correctly.

For example, the Congressional Budget Office released a report in 2011 on trends in the distribution of income.[10] The report accounted for all the sources of income, including some non-taxable sources. It divided income into categories—largely the same kinds discussed in this report. It sorted pensions into a separate category from labor income and capital income. Pensions are, of course, in part compensation for labor. By deferring their income for many years and having the fund invest it, workers also get a lot of capital income out of the deal—many multiples of their original contributions. While it's impossible to allocate the pension income precisely between labor and capital, it leans mostly on the capital side for most workers. The CBO report sorted retirement income into a category called "other." It found that category accounted for about 7 percent of all personal income in 2007.[11]

The CBO's system of categorization was very defensible, but it can also leave a misleading impression. The report found that capital income—as defined on its terms, was very unevenly distributed; only the wealthiest Americans relied on it as a substantial source of income. It is important to remember this definition, though, and not conflate two ideas.

8 Kyle Pomerleau, *The High Burden of State and Federal Capital Gains Tax Rate*, Tax Foundation Fiscal Fact No. 414 (Feb. 11, 2014), http://taxfoundation.org/article/high-burden-state-and-federal-capital-gains-tax-rates, and Kyle Pomerleau, *The United States' High Tax Burden on Personal Dividend Income*, TAX FOUNDATION FISCAL FACT NO. 416 (Mar. 5, 2014), http://taxfoundation.org/article/united-states-high-tax-burden-personal-dividend-income.

9 IRS SOI Table 1.3, above.

10 Congressional Budget Office, *Trends in the Distribution of Household Income Between 1979 and 2007* (October 2011), http://www.cbo.gov/sites/default/files/10-25-HouseholdIncome_0.pdf.

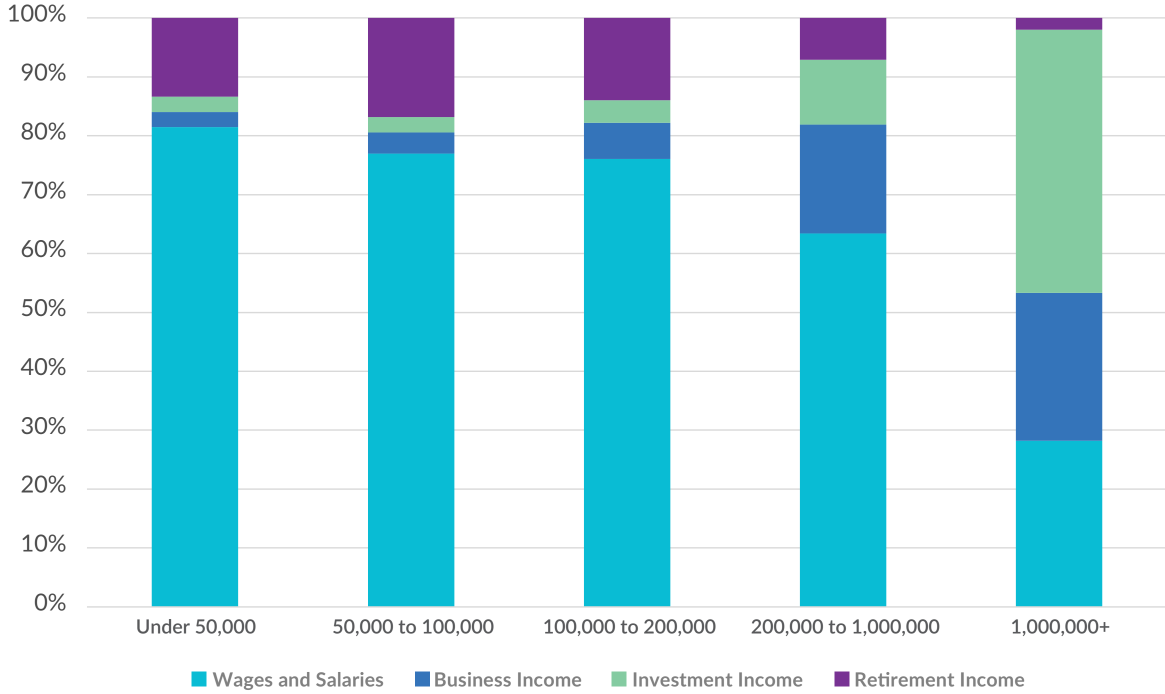
11 This report, which uses IRS figures, finds pension income to be 9 percent of all *taxable* income; the CBO report included some additional non-taxable sources of income in its methodology—most importantly, employer health premiums—and therefore found pension income to be a slightly smaller share of all personal income.

The first idea—that middle-class Americans don't report many dividends or capital gains on their 1040s—is true. A second idea that would appear to follow logically—that middle-class Americans don't earn substantial returns to capital—is false.

Middle-class Americans just wisely put their capital in retirement accounts—where it enjoys a proper tax structure—instead of keeping the money out of retirement accounts and subjecting it to a poor tax structure.

Figure 2: Pensions and IRAs Are Most Important to the Middle-Class

Sources of Personal Income by Income Bracket, 2012



Note: Taxable income only. Business income is net income minus loss from S corporations, partnerships, sole proprietorships, farms, estates, trusts, rent and royalty. Investment income is taxable interest, dividends, and net capital gains minus loss. Retirement income is taxable pensions, IRAs, and social security payments.

Source: IRS SOI Tax Stats - Individual Statistical Tables by Size of Adjusted Gross Income

A look at personal income by income bracket shows the importance of retirement income to the middle class (Figure 2). Retirement income is most important as a source of personal income—about 17 percent—for taxpayers reporting between $50,000 and $100,000 of income. In practice, of course, this means that a minority of middle-class taxpayers—the retirees—rely on this income quite a bit, while the majority, those of working-age, do not.

Retirement income is difficult to account for, and the tax rules governing retirement accounts are not readily obvious to people unfamiliar with tax data. While pensions aren't critical to every analysis of personal income, it is worth remembering a few things: pension income is, in economic terms, mostly a kind of capital income; it is about as important as any other kind of capital income; and it is most important to middle-class workers due to its employer-based structure.

Conclusion

A walkthrough of personal income reveals many things about our tax code and our economy in general. Our personal income tax is largely a tax on labor, primarily because our personal income largely comes from labor. However, there are some varied sources of capital income in the mix as well. While these sources, even when combined together, are small compared to labor income, they are still significant and need to be accounted for well, both by policymakers trying to draw in revenue efficiently, and by economists or journalists attempting to understand the distribution of personal income.

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Appendix

Appendix Table 1. Sources of Income by Income Bracket, 2012, Billions of Dollars

	Wages and Salaries	Business Income	Investment Income	Retirement Income	Total Income
Under 50,000	$1,547	$48	$50	$253	$1,775
50,000 to 100,000	$1,701	$80	$57	$372	$2,241
100,000 to 200,000	$1,600	$129	$80	$294	$2,127
200,000 to 1,000,000	$1,066	$311	$185	$119	$1,698
1,000,000 and Above	$388	$345	$614	$28	$1,393

Source: IRS SOI Tax Stats, Individual Statistical Tables by Size of Adjusted Gross Income

Appendix Table 2. Sources of Income by Year, Billions of Current Dollars

	1990	1995	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Wages and Salaries	$2,599	$3,201	$4,456	$4,565	$4,560	$4,650	$4,922	$5,155	$5,469	$5,842	$5,951	$5,707	$5,837	$6,055	$6,301
Taxable Interest	$227	$155	$199	$198	$149	$127	$125	$162	$223	$268	$223	$168	$140	$120	$112
Tax-exempt Interest	$40	$49	$54	$56	$55	$54	$52	$58	$73	$79	$80	$74	$75	$73	$71
Ordinary Dividends	$80	$95	$147	$120	$103	$115	$147	$166	$199	$237	$219	$163	$184	$195	$260
Qualified Dividends	N/A	N/A	N/A	N/A	N/A	$81	$111	$119	$137	$156	$159	$124	$136	$142	$204
State Income Tax Refunds	$10	$12	$18	$21	$24	$23	$23	$22	$24	$27	$28	$30	$27	$28	$27
Alimony	$4	$4	$6	$7	$7	$6	$7	$8	$8	$9	$9	$9	$9	$9	$9
Sole Proprietorship	$141	$169	$214	$217	$221	$230	$247	$270	$282	$280	$264	$245	$267	$282	$301
Capital Gains	$113	$167	$615	$325	$238	$294	$472	$663	$771	$896	$467	$231	$364	$377	$623
Sale of Non-capital Property	$1	($3)	($1)	($2)	($2)	$0	$3	$4	$4	$4	($8)	($18)	($18)	($14)	$9
Taxable IRA Distributions	$18	$37	$99	$94	$88	$88	$102	$112	$125	$148	$162	$135	$194	$217	$231
Total Pensions and Annuities	$214	$311	$552	$533	$561	$565	$628	$685	$781	$852	$845	$823	$881	$911	$975
Taxable Pensions and Annuities	$159	$221	$326	$339	$358	$373	$394	$420	$450	$491	$506	$523	$559	$581	$613
S-corporation, Partnership, Rent, Royalty, Estate, Trust	$75	$149	$252	$268	$278	$296	$357	$447	$466	$453	$418	$385	$446	$486	$613
Farm	$0	($8)	($9)	($11)	($14)	($12)	($13)	($12)	($15)	($15)	($15)	($14)	($14)	($12)	$8
Unemployment Compensation	$15	$19	$17	$27	$43	$44	$33	$28	$27	$29	$44	$84	$120	$92	$71
Total Social Security Benefits	$100	$119	$187	$197	$206	$214	$232	$252	$340	$382	$416	$457	$478	$491	$527
Taxable social security benefits	$20	$46	$90	$94	$93	$98	$110	$125	$144	$167	$168	$175	$191	$202	$224
Gambling Earnings	N/A	$8	$17	$17	$19	$19	$23	$25	$28	$30	$27	$24	$25	$27	$29
Other	$18	$16	$25	$20	$19	$21	$23	$27	$30	$36	$34	$31	$35	$34	$37
Total Personal Income	$3,439	$4,230	$6,424	$6,231	$6,111	$6,295	$6,887	$7,532	$8,145	$8,811	$8,384	$7,739	$8,208	$8,498	$9,234

Source: IRS, Table A. Selected Income and Tax Items for Tax Years, 1990-2012, in Current Dollars