

Fiscal Fact

Individual Tax Rates Also Impact Business Activity Due to High Number of Pass-Throughs

By

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Introduction

Both President Barack Obama and Republican candidate Mitt Romney have expressed support for lowering the U.S. corporate tax rate—now the highest in the OECD—in order to improve the competitiveness of American businesses.¹ However, their plans for individual income tax rates could not be more different.² President Obama would increase the current top rate on individual income from 35 percent to 39.6 percent, while Romney would cut all individual rates by 20 percent—which would lower the top rate of 35 percent by 7 percentage points to 28 percent.

The implications of these policy differences are considerable because of the tremendous growth in non-corporate business forms over the past thirty years. Today, there are vastly more non-corporate businesses than traditional corporations and they now earn more net income than traditional corporations. Thus, an increase in the top individual tax rates could mean a substantial tax hike on a broad swath of private, or non-corporate, business income.

Trend

To understand the impact of higher tax rates on business income, it is instructive to look at the tremendous growth in taxpayers reporting business income over the past three decades as sole proprietors, S corporations, limited liability corporations (LLCs), and partnerships.

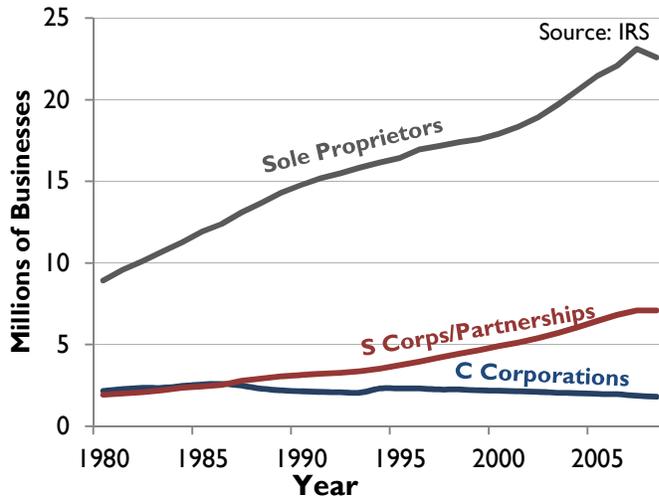
These non-corporate firm types are often referred to as “pass-through” entities because the firm’s profits are passed directly through to the owners and taxed on the owner’s individual tax return. By contrast, the profits

¹ Jackie Calmes & John Cushman, *Obama Unveils Proposal to Cut Corporate Tax Rate*, THE NEW YORK TIMES, Feb. 22, 2012, <http://www.nytimes.com/2012/02/23/business/economy/obama-introduces-plan-to-cut-corporate-tax-rate.html>.

² Richard Rubin, *Romney’s Conflicting Tax Goals Make Burden Shift Likely*, BLOOMBERG, May 2, 2012, <http://www.bloomberg.com/news/2012-05-02/romney-s-conflicting-tax-goals-make-burden-shift-likely.html>.

of traditional C corporations are taxed at the corporate level first before being distributed to the owners (shareholders) who are then taxed again at the individual level.

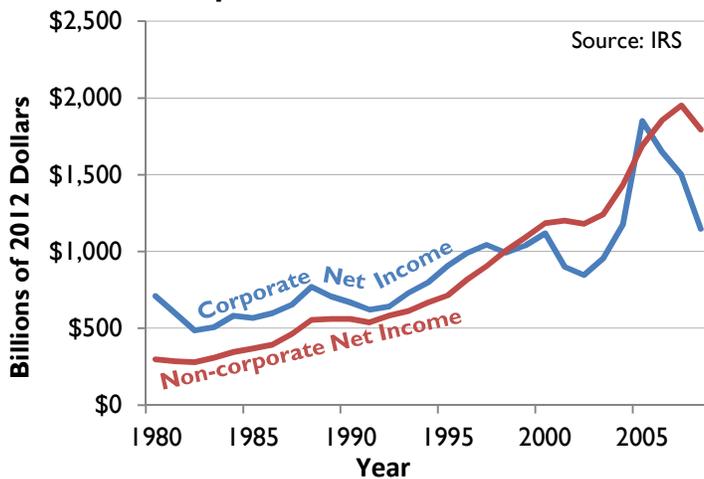
Figure 1: Composition of U.S. Business Forms, 1980 - 2008



Between 1980 and 2008, the total number of pass-through businesses nearly tripled, from roughly 10.9 million to 31.8 million.³ Specifically, as Figure 1 indicates, the number of sole proprietors grew from 8.9 million to 22.6 million, while the number of S corporations and partnerships (which include LLCs) grew from 1.9 million to more than 7 million.

Meanwhile, the number of traditional C corporations declined steadily from 2.2 million to 1.8 million between 1980 and 2008. The popularity of C corporations as a business form ended by the late 1980s when they were exceeded in number by S corps and partnerships. These alternatives to the C corp have continued to grow at such a rapid rate that there are now three and one-half times as many pass-through firms as traditional corporations.

Figure 2: Net Income of Corporate and Non-Corporate Businesses: 1980 - 2008



Over time, as these pass-through firms grew in number, size, and profitability, they began to collectively generate more net business income than traditional C corporations. Figure 2 compares the growth in net income for all pass-through businesses to the growth in net income for all C corps between 1980 and 2008. After adjusting for inflation, net income for C corps roughly doubled during

the period, from \$752 billion to \$1.4 trillion in 2005, and then collapsed to roughly \$1.1 trillion in 2008. By contrast, the combined net income from pass-through businesses increased six-fold, from \$315 billion, after adjusting for inflation, to more than \$1.8 trillion in 2007, before settling to \$1.7 trillion in 2008.

In 1998, the combined net income of pass-through businesses exceeded those earned by C corps for the first time and, except for 2005, have remained above C corp net income in every year since. Indeed, in 2008, the net income of pass-through businesses comprised 61 percent of all net business income.

³ When we reference tax return data, business income is considered the sum of income reported on schedules C, E (excluding royalty and estates), and F. For the data source, see: <http://www.irs.gov/pub/irs-soi/80ot1all.xls>.

It is also interesting to note the relative stability of pass-through business income to the volatility of C corp income. The period between 1999 and 2008, shown on Figure 2, is a good example of how volatile corporate income can be. After the tech bubble burst in 2000, C corp income plunged 24 percent over the next two years, after adjusting for inflation, and then rebounded 119 percent by 2005. After this temporary peak, C corp income fell again by nearly 38 percent over the next three years.

By contrast, pass-through income has not gone through such wild gyrations. After the tech bubble burst in 2000, pass-through business income actually increased in 2001. In 2002, net income fell by just 2 percent but then rebounded by 5 percent in 2003. In the four years after the 2003 tax cuts, the net income of pass-through businesses grew by nearly 60 percent, after adjusting for inflation. In 2008, pass-through business income exceeded C corp receipts by 56 percent.

Who Earns Pass-Through Business Income

It is often assumed that a tax increase on high-income individuals will have little impact on business activity because only 2 or 3 percent of taxpayers with business income are taxed at the highest rates. While this statistic is true, the more economically meaningful statistic is how much overall business income will be taxed at the highest rates. For example, Treasury data for 2007 indicates that 50 percent of all pass-through income is earned by taxpayers subject to the top two tax brackets of 33 percent and 35 percent.⁴

How this income breaks down by income groups can be seen in the most recent IRS data for 2009. In that year, individual taxpayers reported \$896 billion in total business income from all sources—including business and professional income, rents and royalties, partnership and S corporation income, and farm income. After subtracting net losses, individual taxpayers earned \$696 billion in net business income.

As Table 1 indicates, the vast majority (66 percent) of pass-through business income was reported by taxpayers earning more than \$250,000. Millionaire tax returns earned 36 percent of this private business income while taxpayers earning between \$250,000 and \$1 million earned 30 percent. Meanwhile, taxpayers with incomes below \$100,000 earned 13 percent of all private business income.

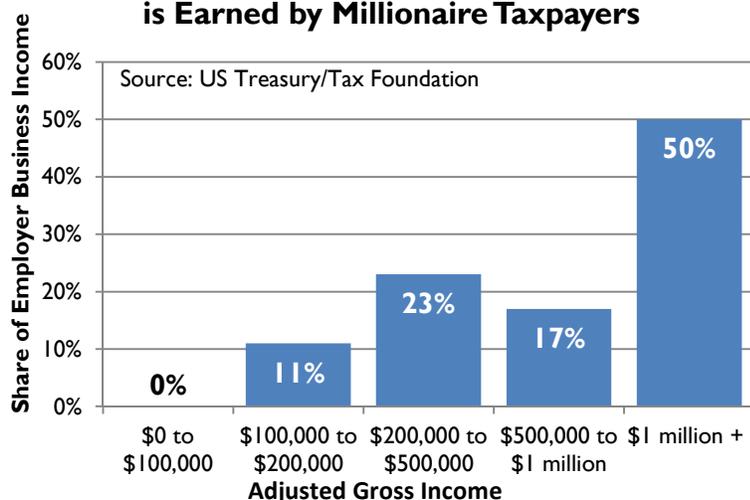
It is also illuminating to look at the distribution of specific types of business income. Table 1 shows the very different distribution of income generated by sole proprietors (business and professional income) versus the income generated by partnerships and S corporations. Whereas only 25 percent of sole proprietor income is reported by taxpayers earning over \$250,000, some 85 percent of partnership and S corp income is reported by these high-income taxpayers. Indeed, more than half of all partnership and S corp income is earned by millionaire taxpayers.

⁴ U.S. Department of the Treasury, Office of Tax Analysis, OTA Technical Paper 4: *Methodology to Identify Small Businesses and Their Owners*, Matthew Knittel, et al., Aug. 2011.

Table I. Distribution of Pass-Through Business Income in 2009

| | under \$100,000* | \$100,000 to \$250,000 | \$250,000 to \$1 million | \$1 million + |
|------------------------------------|---------------------|---------------------------|-----------------------------|---------------|
| All Pass-Through Income | 13% | 21% | 30% | 36% |
| Net Business & Professional Income | 46% | 29% | 19% | 6% |
| Net Partnership & S-Corp Income | 1% | 15% | 34% | 51% |

*includes returns with negative income
Source: Tax Foundation calculations based on IRS data

Figure 3: Half of Employer Business Income is Earned by Millionaire Taxpayers

Of keen interest to policymakers is how many of these pass-through businesses are employers. A recent Treasury report analyzed IRS data from 2007 and found that roughly 4.2 million pass-through business returns—out of 34.7 million overall—were employers. As Figure 3 illustrates, 50 percent of the income generated by these employers accrued to taxpayers with incomes above \$1 million. Fully 90 percent of this business income was generated by employers with incomes above \$200,000.

Conclusion

As lawmakers consider policies to improve the competitiveness of American businesses, they should not forget that individual income tax rates are just as important to business activity as the corporate rate. The various proposals to raise income taxes on high-income earners, either by increasing the top marginal rate, closing “loopholes,” limiting deductions, or implementing a minimum tax, would fall very heavily on America’s non-corporate businesses. These flow-through businesses account for a large percentage of business income and employment in the United States. Raising taxes on them at this time could curtail their hiring and other investment plans, further delaying economic recovery.

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