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

By
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Introduction

Support for lowering the corporate tax rate—now the highest in the OECD—has been expressed by both Democrats and Republicans in order to improve the competitiveness of American businesses. However, they differ in their plans for the individual tax code. While Republicans have proposed lowering the top individual rate from 39.6 percent to 25 percent, in parity with the proposed corporate tax rate, Democrats are less willing to consider lowering the individual tax rate.[1]

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. These businesses face top marginal tax rates higher than 50 percent in some states. Thus, ignoring the top individual tax rate—even while lowering the corporate rate—means the United States will continue to expose a broad swath of business to high tax burdens.

Trends

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 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.

Number of Pass-Through Businesses Tripled While Number of Corporations Declined

Between 1980 and 2010, the total number of pass-through businesses nearly tripled, from roughly 10.9 million to 30.3 million.[2] Specifically, as Figure 1 indicates, the number of sole proprietors grew from 8.9

[1] Michael M. Gleeson & Lindsay McPherson, *Schumer Says Tax Reform Shouldn't Lower Top Individual Rate*, TAX ANALYSTS, Aug. 2, 2013.
[2] 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. *See* Internal Revenue Service, *Statistic On Income Tax Stats—Individual Income Tax Return (Form*

million to 23 million, while the number of S corporations and partnerships (which include LLCs) grew from 1.9 million to more than 7.3 million.

Meanwhile, the number of traditional C corporations declined steadily from 2.2 million to 1.6 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 a half times as many pass-through firms as traditional corporations.

Figure 1. Composition of U.S. Business Forms, 1980 -2010

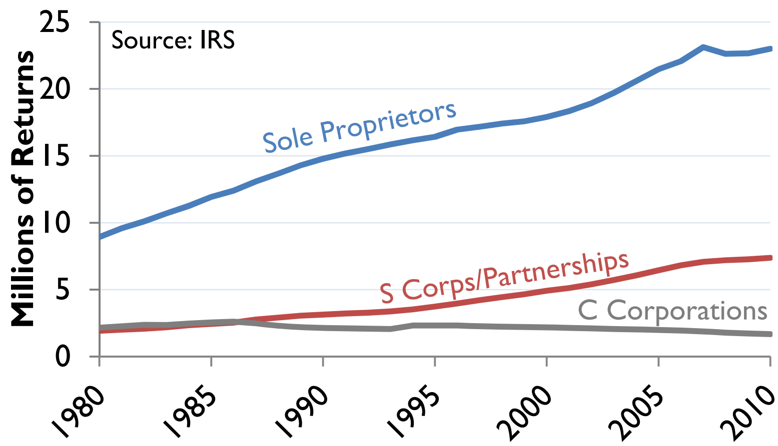
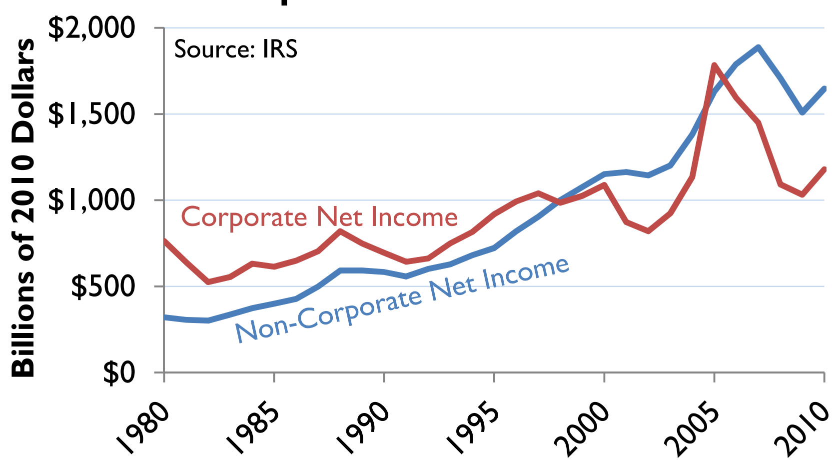


Figure 2. Net Income of Corporate and Non-Corporate Business: 1980 - 2010



Income of Pass-Through Businesses Increased Five-fold while Income of Corporations Doubled

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 2010.[3] After adjusting for inflation, net income for C corps roughly doubled during the period, from $763 billion to $1.7 trillion in 2005, and then collapsed to $1.1 trillion in 2010.[4] By contrast, the combined net income from pass-through businesses increased five-fold, from $320 billion, after adjusting for inflation, to more than $1.6 trillion in 2010.

1040) Statistics, http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax-Return-Form-1040-Statistics; Internal Revenue Service, *Statistics on Income Tax Stats—Integrated Business Data*, http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data.

[3] *Id.*

[4] Internal Revenue Service, *Statistics on Income Tax Stats—Corporate Tax Statistics*, http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Tax-Statistics.

In 1998, the combined net income of pass-through businesses exceeded those earned by C corps for the first time and, except for 2005, has remained above C corp net income in every year since. Indeed, in 2010, the net income of pass-through businesses comprised 54 percent of all net business income.[5]

C Corporation Income is Historically More Volatile than Pass-Through Income

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 2010, 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 33 percent over the next five years.

By contrast, pass-through income has not experienced 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 2010, pass-through business income exceeded C corp receipts by 40 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 two or three percent of taxpayers with business income are taxed at the highest rates. This statistic is misleading. The more economically meaningful statistic is how much overall business income will be taxed at the highest rates. Treasury data for 2007 indicates that 50 percent of all pass-through income is earned by taxpayers subject to the top two tax brackets that year of 33 percent and 35 percent.[6]

Most Pass-Through Income is Earned by Taxpayers with AGIs Greater than $200,000

How this income breaks down by income groups can be seen in the most recent IRS data for 2010. In that year, individual taxpayers reported $932 billion in total business income from all sources—including business and professional income, rents and royalties, partnership and S corporation income, and farm income.

As Table 1 indicates, the majority (59.2 percent)[7] of pass-through business income was reported by taxpayers earning more than $200,000.[8] Taxpayers with AGIs greater than $1 million earned 29.1 percent of this private business income while taxpayers earning between $200,000 and $1 million earned 30 percent. Meanwhile, taxpayers with incomes below $100,000 earned 26.6 percent of all private business income.

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[5] *Id.*

[6] U.S. Department of the Treasury, Office of Tax Analysis, Matthew Knittel, et al., OTA Technical Paper 4: *Methodology to Identify Small Businesses and Their Owners*, Aug. 2011, http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf.

[7] The sum of column three, four, and five for "All Pass Through Income."

[8] Internal Revenue Service, *Statistics on Income Tax Stats—Individual Income Tax Return (Form 1040) Statistics*, http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax-Return-Form-1040-Statistics.

Table 1. Distribution of Pass-Through Business Income in 2010 by Taxpayer AGI

	under $100,000	$100,000 to $200,000	$200,000 to $500,000	$500,000 to $1 million	$1 million +
Business or Professional	53.4%	18.4%	16.7%	5.4%	6.2%
Partnerships and S-Corporation	8.7%	10.6%	19.8%	15.3%	45.6%
All Pass Through Income	26.6%	14.2%	18.7%	11.3%	29.1%

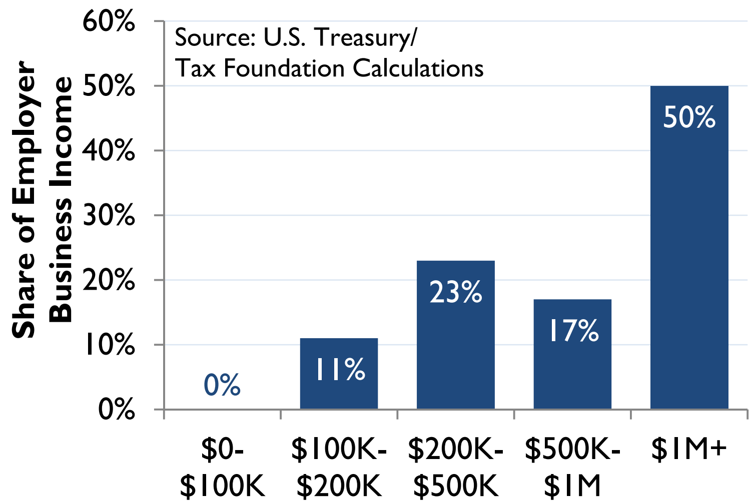
The Distribution Pass-Through Income Differs Greatly by Business Type

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 28 percent of sole proprietor income is reported by taxpayers earning over $200,000, some 81 percent of partnership and S corp income is reported by these high-income taxpayers. Indeed, nearly half of all partnership and S corp income is earned by taxpayers with adjusted gross incomes higher than $1 million.

A Vast Majority of Pass-Through Businesses with Employees Earn More than $100,000

It is also important to note how many of these pass-through businesses are employers. A Treasury report from 2011 analyzed IRS data from 2007 and found that roughly 4.2 million pass-through business returns—out of 34.7 million overall—were employers.[9] As Figure 3 illustrates, 50 percent of the income generated by these employers accrued to taxpayers with incomes above $1 million. Fully ninety percent of this business income was generated by employers with incomes above $200,000.

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



Top Marginal Income Tax Rates on Pass-Through Businesses

Although the top federal tax rate on pass-through income is 39.6 percent, this is not the only tax for which a pass-through business is liable. Other taxes they must pay include state and city income taxes and self-employment taxes. These taxes typically add up to a relatively high top marginal tax rate on their income.

Take for example a sole proprietorship in New York City with net income greater than $5 million (See Table 2). The business would pay the 39.6 percent top individual federal income tax rate. On top of this, the state income tax rate is 8.8 percent and the city's rate is 4.2 percent (minus the deductibility of state

[9] U.S. Department of the Treasury, Office of Tax Analysis, Matthew Knittel, et al., OTA Technical Paper 4: *Methodology to Identify Small Businesses and Their Owners*, Aug. 2011, http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf.

taxes against one's federal tax rate). The business also has to pay self-employment taxes of 3.8 percent (1.45 percent each for the employee and employer side of the Medicare tax plus the new 0.9 percent Medicare tax).[10] Add an additional 1.18 percent to account for Pease, which limits itemized deductions for those whose AGIs are higher than $250,000. Finally, divide the total by 1.0145, assuming the employer's portion of the Medicare tax is born by the worker. The total top marginal tax rate on the sole proprietorship in New York City is 51.6 percent.[11]

This method can be used for each state to find the top marginal tax rate on pass-through businesses. Table 3, below, shows the top marginal tax rate on sole proprietorships, partnerships, and S corps in each state. Sole proprietorships and partnerships pay rates that range from 42.6 percent in states like Wyoming, New Hampshire, Nevada, and Florida with no state income taxes to rates as high as 51.8 percent in California. The average top marginal rate for sole proprietorships and partnerships is 47.5 percent.

Table 2. Calculation of Top Marginal Income Tax on Sole Proprietorship in New York City

Top Federal Income Tax Rate		39.60%
Top State Income Tax Rate	+	8.80%
Top Local Rate	+	4.20%
Deductibility of State/Local Taxes	-	5.15%
Self-Employment Taxes (Medicare)	+	3.80%
Pease Provision	+	1.18%
Subtotal:		**52.43%**
Assuming Medicare Tax is Born by Worker	÷	1.0145
Total Top Marginal Tax Rate[12]	**=**	**51.68%**

For S corps, top marginal tax rates are similar, though slightly lower due to the lack of self-employment taxes. S corps in states with no income tax rates are taxed at the top marginal federal tax rate of 39.6 percent. The top rate for S corps is in California, with a top rate of 48.8 percent. The average rate paid by S corps in the United States is 44.5 percent.

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. Pass-through businesses are currently facing top marginal rates on average between 44.5 percent and 47.5 percent and as high as 51.8 percent in California. These pass-through businesses account for a large percentage of business income and employment in the United States. Raising taxes on them could curtail their hiring and other investment plans, putting more strain on an already struggling economy.

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[10] Since this business's income is greater than $113,700 dollars, it does not have to pay the Social Security portion of the self-employment tax of 12.4 percent on the 5 millionth dollar.

[11] Gerald Prante & Austin John, *Top Marginal Effective Tax Rates by States and by Source of Income, 2012 Tax Law (as enacted in ATRA)* (Feb. 3, 2013). This number also assumes that the employer portion of the Medicare tax is born by the worker.

[12] The formal equation is as follows: $Top\ Marginal\ Tax\ Rate = (Top\ Federal\ Income\ Tax + [(State\ and\ Local\ Taxes) * (1 - Top\ Federal\ Income\ Tax)] + Self\ Employment\ Taxes + Pease\ Provision) \div 1.0145$

Table 3. Top Marginal Tax Rates for Pass-Through Businesses by State, 2013

Sole Proprietorships			S-Corporations		
California	1	51.8%	California	1	48.8%
Hawaii	2	50.4%	Hawaii	2	47.4%
New York	3	50.2%	New York	3	47.2%
Oregon	4	49.8%	Oregon	4	46.8%
New Jersey	5	49.2%	District of Columbia	(5)	46.2%
District of Columbia	(6)	49.1%	New Jersey	5	46.2%
Vermont	6	49.1%	Vermont	5	46.2%
Maryland	7	49.0%	Maryland	7	46.1%
Maine	8	48.9%	Maine	8	45.9%
Minnesota	9	48.5%	Minnesota	9	45.5%
North Carolina	10	48.4%	North Carolina	9	45.5%
Wisconsin	10	48.4%	Wisconsin	9	45.5%
Ohio	12	48.3%	Ohio	12	45.4%
Idaho	13	48.2%	Idaho	13	45.3%
Kentucky	13	48.2%	Arizona	14	45.0%
Arizona	15	48.0%	Montana	14	45.0%
Delaware	16	47.9%	Delaware	16	44.9%
Montana	16	47.9%	Nebraska	16	44.9%
Nebraska	16	47.9%	Connecticut	18	44.8%
Connecticut	19	47.8%	West Virginia	19	44.7%
West Virginia	20	47.7%	Missouri	20	44.5%
Georgia	21	47.4%	Georgia	21	44.4%
Missouri	21	47.4%	Kentucky	21	44.4%
Rhode Island	21	47.4%	Rhode Island	21	44.4%
Iowa	24	47.2%	Iowa	24	44.3%
Virginia	24	47.2%	Virginia	24	44.3%
Massachusetts	26	47.0%	Massachusetts	26	44.0%
Oklahoma	27	46.9%	Oklahoma	26	44.0%
Illinois	28	46.8%	Illinois	28	43.8%
Mississippi	28	46.8%	Mississippi	28	43.8%
South Carolina	28	46.8%	South Carolina	28	43.8%
Utah	28	46.8%	Utah	28	43.8%
Kansas	32	46.7%	Kansas	32	43.7%
New Mexico	32	46.7%	New Mexico	32	43.7%
Colorado	34	46.6%	Colorado	34	43.6%
Indiana	34	46.6%	Indiana	34	43.6%
Arkansas	36	46.5%	Arkansas	36	43.5%
Michigan	36	46.5%	Michigan	36	43.5%
Pennsylvania	36	46.5%	North Dakota	38	43.2%
North Dakota	39	46.2%	Louisiana	39	43.0%
Louisiana	40	46.0%	Alabama	40	42.6%
Alabama	41	45.6%	Pennsylvania	40	42.6%
Alaska	42	42.6%	Alaska	42	39.6%
Florida	42	42.6%	Florida	42	39.6%
Nevada	42	42.6%	Nevada	42	39.6%
New Hampshire	42	42.6%	New Hampshire	42	39.6%
South Dakota	42	42.6%	South Dakota	42	39.6%
Tennessee	42	42.6%	Tennessee	42	39.6%
Texas	42	42.6%	Texas	42	39.6%
Washington	42	42.6%	Washington	42	39.6%
Wyoming	42	42.6%	Wyoming	42	39.6%
U.S. Average		47.5%	U.S. Average		44.5%

Source: Gerald Prante & Austin John, *Top Marginal Effective Tax Rates by States and by Source of Income, 2012 Tax Law (as enacted in ATRA)*, Feb. 3, 2013

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