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Growing Amount of Business Income Taxed by the Individual Income Tax Code

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A commonly overlooked trend affecting corporate and individual tax collections has been the dramatic rise in alternative corporate structures, such as subchapter-S corporations and sole proprietorships, and the way this rise has caused business-source income to move from the corporate tax system into the individual income tax system.

These business structures are now taxed under different rules than traditional C corporations, often making them more attractive to business owners who must decide which tax path to take. While S corporations are similar to ordinary C corporations in that they provide owners with such benefits as limited liability and freely transferable ownership rights, unlike C corporations, all S corporation income is taxed through the personal income tax code (using Schedules B, C, D, E, and F), not the corporate income tax code.

This is important for two reasons. First, income earned through an S corporation or sole proprietorship is taxed only once—just as any regular income such as wages—whereas income earned through a C corporation is taxed twice: once through the corporate income tax, and again when investors pay individual income taxes on dividends or capital gains.

Second, as the percentage of business activity conducted through S corporations and sole proprietorships increases, an increasing amount of tax will be collected through the personal income tax compared to the corporate income tax. This is difficult to see right now because corporate income tax revenue is experiencing an almost unprecedented boom, mostly a result of a strong economy. (Please see related "Fiscal Fact" at http://www.taxfoundation.org/publications/show/1478.html.)

Rapid Growth in S-Corps and Sole Proprietorships

Since S-corp earnings are taxed only once at the individual owner's level, the double taxation of earnings is eliminated. S corporations agree to certain limitations in exchange for this benefit, including limiting shareholders to 75 or fewer and limiting ownership to U.S. citizens and resident aliens.

The benefits of this legal organizational structure have led to a 50 percent increase in the number of businesses filing as S corporations between 1990 and 2003. From 2002 to 2003 alone, the number of S corporations rose by 4 percent to 3.3 million. According to the Internal Revenue Service, 1997 was the first year that S corporations became the most common form of corporate business.

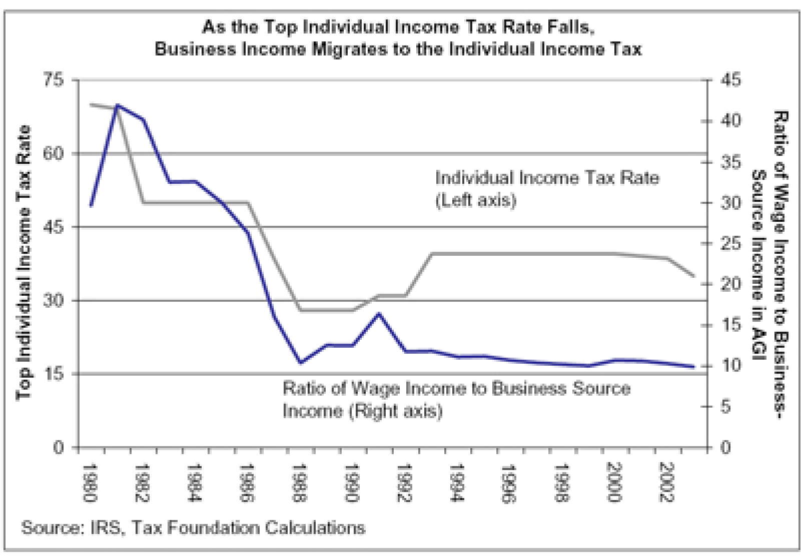
Over the past two decades, the United States has also seen steady growth in the number of sole proprietorships. In 1985, there were 11.9 million non-farm sole proprietorships. By 1990, this number had grown to 14.8 million—an increase of 23.5 percent—and by 2003 the number had grown to 19.7 million.

Income Shifts from Corporate to Individual Tax Code

The decision by a business owner to file a tax return as a regular C-corp (in the corporate tax system) or as an S-corp or sole proprietor (in the individual tax system) is often determined by the tax rates levied on individuals compared to corporations.

As Figure 1 shows, a cut in the top tax rate on individuals is often followed by a significant decrease in the ratio of wage income to business-source income in adjusted gross income (AGI). This is because more business-source income flows into AGI. This relationship appears to hold throughout the period from 1980 to 2003.

Figure 1: Income Shifting and Tax Rates, 1980-2003 (Click to enlarge)



The ratio of wage income to business-source income can be thought of as the amount of wage income in AGI for every dollar of business income in AGI, where business-source income is defined as income reported by sole proprietorships, partnerships, and farms. In 1981, there was approximately $74 in wage income in AGI for every dollar of business-source income in AGI.

As a result, in the early 1980s the personal income tax was almost purely a wage tax. But by 2003, it had also become a business tax. The ratio of wage to business income had fallen below 10-to-1 due to more business income being claimed on individual income tax forms.[1]

Conclusion

The existence of a dual corporate structure creates inequalities between companies in similar economic situations, but with different legal structures. Given the attractiveness of incorporating a business in a form that allows the owner to pay taxes solely on the individual side of the tax code, the popularity of S corps, sole proprietorships and partnerships will likely continue to grow if individual income tax cuts continue to outpace corporate tax reductions. (For options for reforming the corporate tax system, please see http://www.taxfoundation.org/publications/show/1479.html.)

Footnotes

[1.] These legal changes have a direct adverse effect on the usefulness of individual income tax statistics in trying to analyze income and tax distributions across different time periods. These changes may also lead policymakers to overstate or understate the impact on individual tax revenues of cutting or raising taxes on what may appear to be mostly wages, yet is in large part business income.

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