TAX FOUNDATION
Since 1937

SPECIAL REPORT

September 2010
No. 185

Over One-Third of New Tax Revenue Would Come from Business Income If High-Income Personal Tax Cuts Expire

By
Scott A. Hodge
President
Tax Foundation

Introduction

The impending expiration of the 2001 and 2003 tax laws has spurred a debate over how much business activity will be affected when statutory personal income tax rates rise.

In the U.S. over the past 30 years, non-corporate businesses have come to dominate the nation's job creation process. S-corporations, limited liability corporations, partnerships and sole proprietorships – all of these non-corporate business forms are called pass-through entities because instead of their profits being taxed at the corporate level, they are passed through to the individual owners who report the business's profits on their personal tax returns.

There is a good chance that some or all of those personal tax rates will increase on

Key Findings

- *The frequently cited statistic that only 2 or 3 percent of tax returns with business income pay tax in the top two brackets and would face higher tax rates in 2011 is factually accurate but misleading. Those 2 or 3 percent represent the fortunes of larger, growing, profitable businesses whose continued prosperity is important to economic recovery.*
- *Assuming that business income is the last dollar of income a taxpayer earns, Tax Foundation economists estimate that 39 percent of the $629 billion tax increase on high-income taxpayers proposed in the Obama 2011 budget would be extracted from business income. Over ten years then, an extra $246 billion would be taken out of business income.*
- *In 2007, the federal government taxed more business income under the individual income tax code than under the traditional corporate tax code.*
- *More than 74 percent of tax filers in the highest tax bracket report business income, compared to 20 percent of those at the lowest bracket.*
- *Of the roughly $864 billion in taxable business income reported on individual tax returns in 2008, nearly 68 percent was claimed by taxpayers earning over $200,000 and 35 percent was claimed by taxpayers earning over $1 million.*

January 1, 2011. If current law is maintained, tax rates will be higher for all earners' wages, capital gains and dividends. If the Democratic Congress and President Obama enact their plan, the lower income brackets will be spared. Here we focus on the latter scenario: that the Democratic plan for higher tax rates on upper-income wages, capital gains and dividends becomes law.

Supporters of the administration's proposal to raise taxes on high-income individuals try to discount the impact of these policies on private enterprise by citing the relatively small number of business owners who pay the highest tax rates. But the fact that "only" 2 or 3 percent of taxpayers with business income will face higher taxes is quite meaningless to the debate.

Many lawmakers and economists advocate keeping today's lower rates for fear that higher tax rates will damage the productive capacity of businesses. In support, they cite the Joint Committee on Taxation (JCT) estimate that in 2011, people in the top two tax brackets will report half of the approximately $1 trillion in total net business income reported on individual tax returns.[1] That means allowing the top two tax rates to increase will hit a great deal of business income.

On the other side, advocates for higher tax rates claim that the impact on business will be negligible because only 3 percent of individual income tax returns with business income will be affected. That is also from the JCT. Both statistics are correct, but which is more important? Here we assert that the percentage of taxpayers affected is not the economically important statistic. Letting the Bush-era tax cuts expire for the top two brackets will hit much of the nation's non-corporate business income, earnings that are highly productive and sensitive to taxation.

Murky Personal Income Tax Data

What neither side of this debate knows with certainty is how many of these taxpayers with business income are owners of small businesses, partners in a law firm, shareholders in a large S-corporation, or angel investors in the next Google. Due to privacy concerns and the limited information contained on tax returns, published IRS data are simply not detailed enough to link a specific taxpayer with business income to a specific type of business or enterprise.

As a result of this information void, we are left to infer from the available data which taxpayers will be most impacted by the higher income tax rates that may become law in 2011. While we don't know which firms are big or small, the data do yield some relevant facts:

- In 2007, there were 30.1 million private businesses (sole proprietors, S-corporations, LLCs, and partnerships), nearly three times as many as there were in 1980.
- In 2007, more business income was taxed under the individual income tax code than under the traditional corporate tax code.
- More than 74 percent of tax filers in the highest tax bracket report business income, compared to 20 percent of those at the lowest bracket.
- Of the roughly $864 billion in taxable business income reported on individual tax returns in 2008, nearly 68 percent was claimed by taxpayers earning over $200,000 and 35 percent was claimed by taxpayers earning over $1 million.

1 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.

- In 2011, more than 40 percent of private business income will be earned by taxpayers paying the top marginal rate, currently scheduled to rise to 39.6 percent unless Congress acts.

Finally, we can measure the impact of the tax increase on taxpayers with business income with such tools as the Tax Foundation's Individual Microsimulation Model. Assuming that that business income is the last dollar of income a taxpayer earns, Tax Foundation economists estimate that 39 percent of the $629 billion tax increase on high-income taxpayers proposed in the Obama 2011 budget would be extracted from business income. Over ten years then, an extra $246 billion would be taken out of business income.

Growth in "Pass-Through" Businesses Since 1980

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 owners' individual tax returns. 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.

In the mid-1950s, entrepreneurs had few options when choosing a legal form for a new business. Choosing to organize as a C-corporation would give them liability protection, but the federal government would then impose two layers of taxation — the corporate level and the personal level — not a tax-friendly choice when the top personal rate was 91 percent and the top corporate rate was 50 percent. Alternatively, they could forgo the liability protection and form a partnership or operate as a sole proprietor and enjoy a single layer of tax.

In 1958, Congress and the Eisenhower administration created the S-corporation which provided entrepreneurs with liability protection and a single level of taxation. Congress did, however, restrict S-corporations in other respects. Among other things, they had to be domestic firms with a single class of stock and a limited number of shareholders.[2]

If the tax cuts for high-income individuals expire, much of the new revenue will be extracted from business income, an estimated $246 billion over 10 years. Despite considerable murkiness of available data, it is reasonable to assume that taxing business income by this amount will have a detrimental impact on business activity.

In the 1970s came the advent of the limited liability company (LLC), which also offered entrepreneurs liability protection coupled with a single layer of tax, but without the other restrictions that applied to S-corporations.

The number of pass-through businesses began to grow dramatically in the 1980s. The emergence of the LLC as a popular business form, coupled with the tax rate cuts during the decade, proved to be an attractive combination for private business. Under Reagan, the top individual income tax rate was cut from 70

2 For a history, see the S-Corp Association, http://www.s-corp.org/our-history/, and Jeremy A. Leonard, "A Closer Look at the Business Tax Burden: C-Corps, S-Corps, and the Impact of the Federal Budget's 2011 Tax Proposals," Economic Report ER-701, Manufacturers Alliance, June 2010. http://www.mapi.net/Filepost/ER-701.pdf

percent to 50 percent in 1981 and was reduced further to 28 percent as part of the 1986 tax reform act.

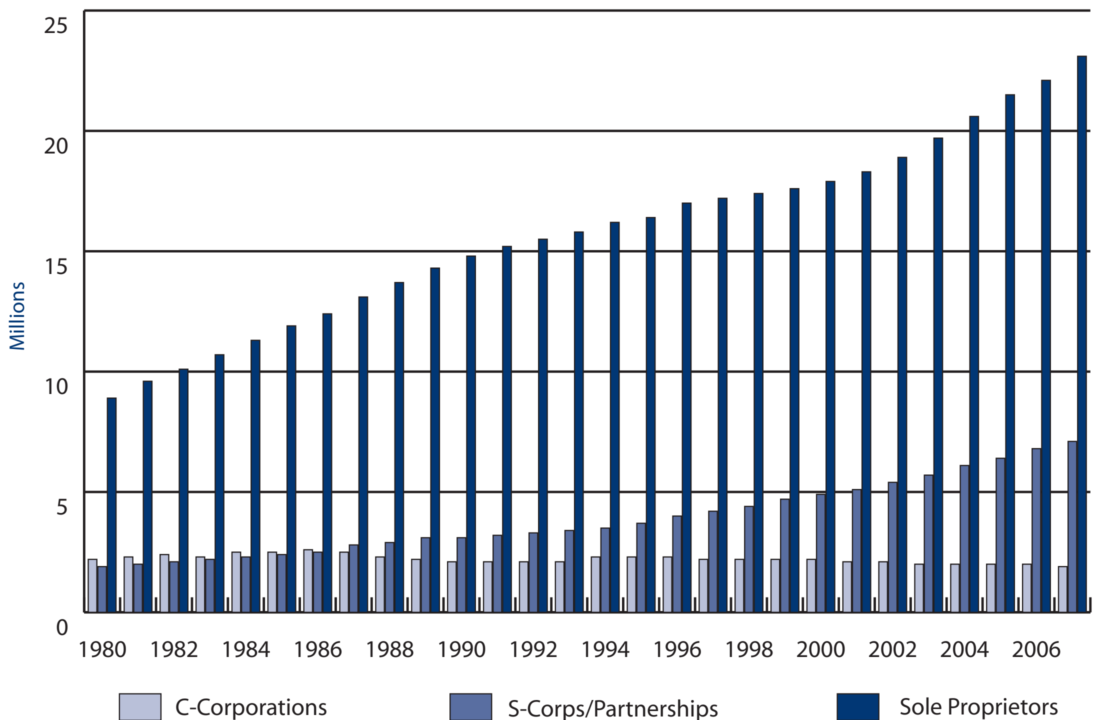
As Figure 1 indicates, the number of traditional C-corporations declined steadily from 2.2 million to 1.9 million between 1980 and 2007. Meanwhile the number of pass-through businesses nearly tripled, from roughly 10.9 million to more than 30 million. The number of sole proprietors grew from 8.9 million to more than 23 million, and the number of S-corporations and partnerships (which include LLCs) grew at a faster rate from 1.9 million to more than 7 million. 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.

Over time, as these pass-through firms grew in number, size, and profitability, they began to collectively generate more taxable business income than traditional C-corporations. Figure 2 compares the growth in net receipts for all pass-through businesses to the growth in net receipts for all C-corps between 1980 and 2007. After adjusting for inflation, net receipts for C-corps roughly doubled during the period, from $752 billion to $1.4 trillion. By contrast, the combined net receipts from pass-through businesses increased six-fold, from $315 billion, after adjusting for inflation, to more than $1.8 trillion.

In 1998, the combined net receipts of pass-through businesses exceeded those earned by C-corps for the first time and, except for 2005, have remained above C-corp receipts in every year since. Indeed, in 2007, the net receipts of pass-through businesses comprised 56 percent of all business receipts.

Figure 1

Forms of U.S. Businesses
Calendar Years 1980 – 2007



Source: IRS, Statistics of Income

It is also interesting to note the relative stability of pass-through business receipts to the volatility of C-corp receipts. The period between 1999 and 2007, shown on Figure 2, is a good example of how volatile corporate receipts can be. After the tech bubble burst in 2000, C-corp receipts plunged 25 percent over the next two years, after adjusting for inflation, and then rebounded 117 percent by 2005. After this temporary peak, C-corp receipts fell again by nearly 19 percent over the next two years.

By contrast, pass-through receipts have not gone through such wild gyrations. After the tech bubble burst in 2000, pass-through business receipts actually increased in 2001. In 2002, receipts fell by just 2 percent but then rebounded by 5 percent in 2003. In the four years after the 2003 tax cuts, the net receipts of pass-through businesses grew 57 percent, after adjusting for inflation. By 2007, pass-through business receipts exceeded C-corp receipts by 30 percent.

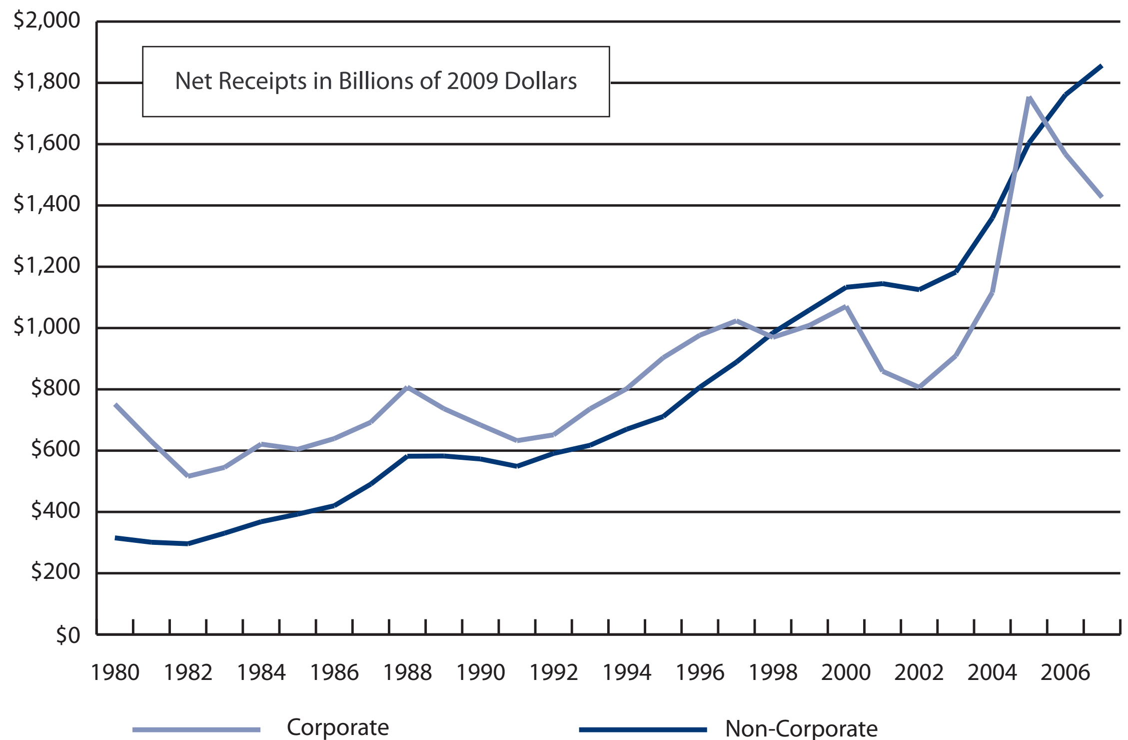
Which Income Groups Report the Most Business Income?

According to the most recent IRS data for 2008, taxpayers reported $969 billion in total pass-through business income from all sources, including S-corporations, partnerships, rents, and farms. After subtracting returns with losses or no taxable income, roughly $864 billion of this total was claimed on taxable returns, i.e., those returns with a positive tax liability.

Figure 3 shows the distribution of this $864 billion in business income by income group. As the chart makes clear, high-income taxpayers report the largest share of business income. Indeed, the largest share – some $303 billion of the total, or 35 percent – was reported on tax returns of filers earning more than $1 million.

Figure 2

Income Earned by Pass-Through and Corporate Businesses
Calendar Years 1980 – 2007



Source: IRS, Statistics of Income

Overall, taxpayers earning more than $200,000 – the group that President Obama has targeted for higher tax rates – reported 68 percent of all pass-through business income, a total of $588 billion in all.

By contrast, just 16 percent of all pass-through business income, or $139 billion in total, was reported by taxpayers earning less than $100,000. About the same amount was reported by taxpayers within the $100,000 to $200,000 income group. This means that the combined business income of every taxpayer earning up to $200,000 was still less than the total business income of taxpayers earning more than $1 million.

As Income Rises, So Does the Share of Business Income

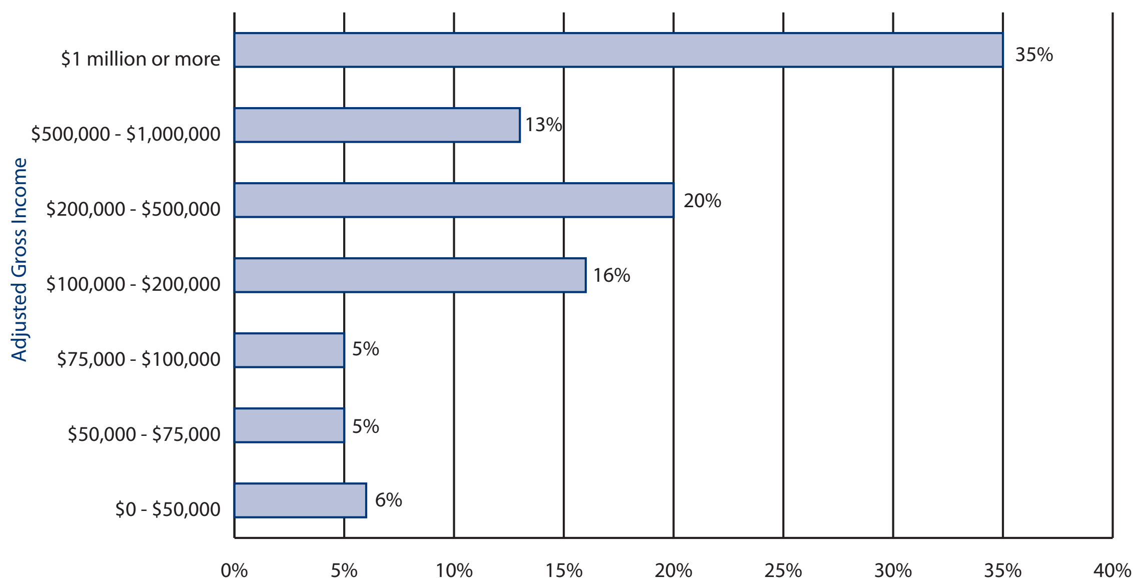
IRS data tell us that 68 percent of all business income is declared on the tax returns of people with at least $200,000 in AGI, but the Tax Policy Center (TPC) uses its microsimulation model to show the distribution of business income earned – and taxes paid – by marginal tax bracket in 2011, assuming the top tax rates go up as President Obama and Congressional Democrats have proposed (see Table 1).

A greater percentage of taxpayers in the highest tax brackets report business income than do taxpayers in any other tax bracket. For example, 74 percent of taxpayers who will be hit by the new 39.6 percent bracket (currently 35 percent) report business income while only 20 percent of taxpayers within the lowest 10 percent bracket report business income. Similarly, about 66 percent of taxpayers in the proposed 36 percent bracket (currently 33 percent) report business income while 26 percent of those in the 25 percent bracket do.

The TPC table also estimates the percentage of positive business income that will be reported by people in each tax bracket. Of the estimated $962.5 billion in positive business income in 2011, 40.3 percent of it will be earned by people in the 39.6 percent tax bracket, and another 4 percent of business income will be reported by people in the 36 percent tax bracket.

Figure 3

Percentage of All Business Income Reported on Taxable Personal Income Tax Returns by Income Group Calendar Year 2008



Source: IRS, Statistics of Income

How Does Business Income Compare to Other Sources of Income?

For most Americans, wage and salary income is the primary source of income. Indeed, in 2008, wage and salary income comprised 69 percent of the adjusted gross income reported by all taxpayers to the IRS. Business income comprised 11 percent of total AGI, capital gains income amounted to 6 percent, and dividends were 2 percent.

However, business income comprises a far greater share of total earnings for high-income taxpayers than for lower-income taxpayers. Figure 4 compares the three largest sources of income for taxpayers: wage and salary income, capital gains income, and business income. For taxpayers with incomes below $200,000, wages and salaries comprise roughly 80 percent of overall earnings. By contrast, business income amounted to just 4 percent of earnings for taxpayers under $50,000 and 7 percent for taxpayers at about $200,000. Capital gains comprised the smallest share of their total earnings at less than 2 percent.

For taxpayers with total earnings between $200,000 and $1 million, salary income still comprises the majority of their total earnings, but the share of their total earnings derived from business activity increases with their incomes. For example, business income comprises 18 percent of total earnings for taxpayers between $200,000 and $500,000 but comprises 28 percent of total earnings for taxpayers between $500,000 and $1 million.

The story for millionaires is quite different. While 28 percent of their total earnings are derived from business activity, the share derived from salaries is just 31 percent. Capital gains income is the third major share at 30 percent. Dividends and interest comprise the rest.

Some analysts assert that if business income comprises only one-third of total earnings on a particular high-income tax return, that taxpayer is not truly a "business owner" for whom rising tax payments could damage productive, job-creating economic activity. Instead, the argument goes, he is probably a passive investor in other businesses. There are at least three reasons that this is probably the wrong reading of the data.

First, many high-income families are dual-earner couples, and published IRS tax data include only the combined income, so we can't even pinpoint which spouse is generating the business income, or how the salary income is split.

Second, the principal form of savings for many business owners is the business itself. Thus they may pay themselves a salary but take minimal profits out as "income" so that they can reinvest any profits back into the business.

Finally, for business owners who also work in the firm, the proper analysis would combine their business income with the wages they draw from the business, since both stem from their ownership and operation of the business.

Table 1

Distribution of Business Income by Statutory Marginal Tax Rate, 2011
Baseline: Current Policy Plus Administration's Upper-Income Tax Proposals

Statutory Marginal Income Tax Rate	Number of Tax Units Reporting Business Income (Thousands)	Percent of Total Reporting Business Income	Percent of Bracket Reporting Business Income	Amount of Positive Business Income (Billions)	Percent of Total
Non-filers	981	2.7	4.9	$3.1	0.3
0	9,201	25.5	31.4	$59.5	6.2
10	4,951	13.7	19.9	$45.9	4.8
15	10,777	29.9	21.7	$113.1	11.8
25	6,180	17.2	26.2	$114.2	11.9
26 (AMT)	932	2.6	46.8	$37.5	3.9
28 (Regular)	1,082	3.0	36.4	$48.6	5.0
28 (AMT)	1,028	2.9	59.7	$113.5	11.8
36	272	0.8	65.7	$39.0	4.0
39.6	622	1.7	74.2	$388.2	40.3
All	36,026	100.0	23.2	$962.5	100.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

Deductions as a Clue to Business Activity

Another clue to identifying taxpayers engaged in business activity is the tax deductions they take. One of the more significant deductions for many businesses is the domestic manufacturing activities deduction, which tax professionals simply refer to by its tax code number, the "Section 199 deduction."

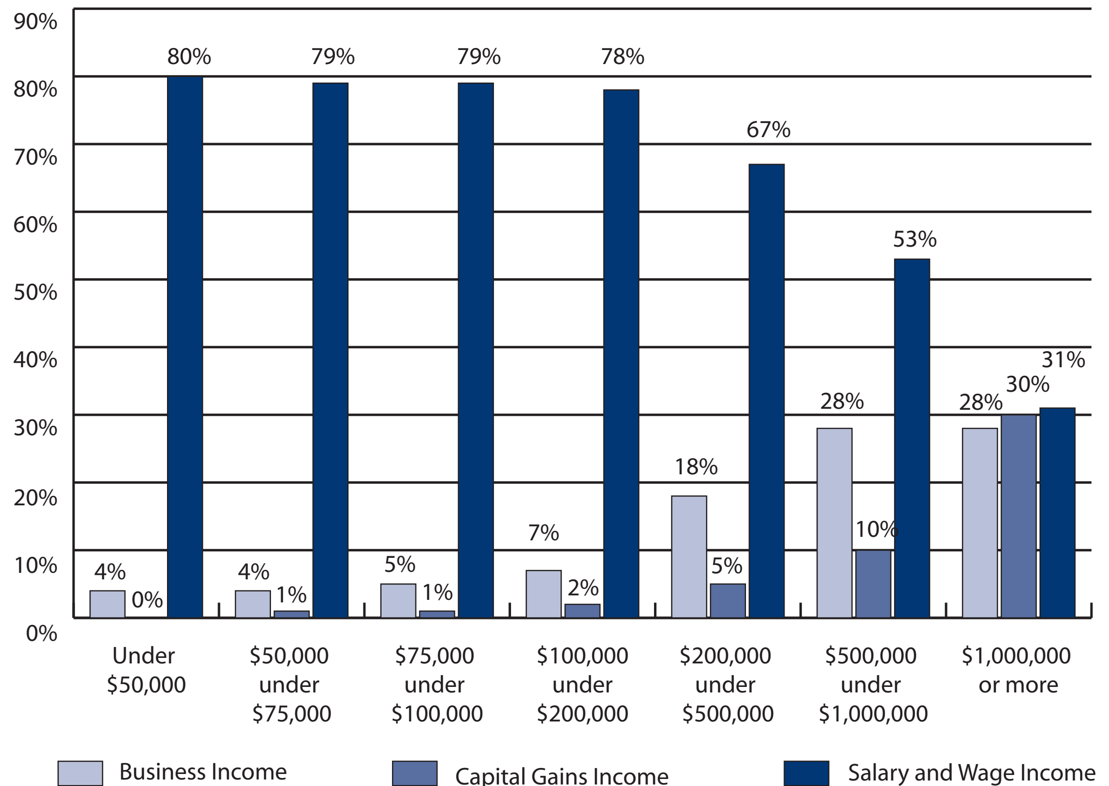
Section 199 allows companies to deduct up to 9 percent of their net income from domestic manufacturing activities. While the credit is not available to businesses engaged in services, finance, or information technology, it is available to an incredibly broad swath of "manufacturing" activities and taxpayers, be they individuals, C-corporations, farmers, estates, or the owners of S-corporations.

Production activities that qualify for the credit include: the manufacturing of goods; making of clothing; extraction of minerals; processing of food (for wholesale, not retail); software development: and, producing music recordings or films. Some construction activities also qualify, including: the construction or substantial renovation of residential and commercial buildings; infrastructure projects such as roads, power lines, water systems, and communications facilities; and, engineering and architectural services relating to qualified construction projects.[3]

However, firms cannot deduct the income from production activities that are for retail consumption, only for those meant for wholesale distribution. For example, grinding hamburger meat for wholesale distribution is a qualified activity, but if a fast-food restaurant

Figure 4

Business Income Relative to Other Income Sources
Calendar Year 2008



Source: IRS, Statistics of Income

grinds hamburger meat for take-out sales it does not qualify for the credit.

As Table 2 shows, in 2008, 441,469 individual tax returns claimed $6.7 billion in manufacturing deductions. The largest number of those returns were taxpayers earning between $100,000 and $200,000 – comprising 29 percent of the total – and taxpayers earning between $200,000 and $500,000 – 23 percent of the total.

However, more than two-thirds (or $4.2 billion) in total 199 credits were claimed by taxpayers with more than $1 million in income. This would indicate that these taxpayers' business income is generated by substantial manufacturing production activities.

How Much of the Impending Tax Increase Will Be Borne by Businesses?

One of the ways of isolating the effects of tax changes on different taxpayers is to use a tax simulation model such as the Tax Foundation's Individual Microsimulation Model. The model simulates changes in tax policy using a statistically representative sample of about 150,000 individual tax returns (called the Public Use File) made available to researchers by the IRS.

Table 2

Section 199, Manufacturing Production Activities Credit
Calendar Year 2008

	Returns Claiming Manufacturing Credit	Percent of Returns Claiming Credit	Amount of Manufacturing Credit Claimed (Thousands)	Percentage of Total Credit Claimed
Taxable returns, total	441,469	100%	$6,711,600	100%
Under $50,000	32,783	7%	$66,707	1%
$50,000 under $75,000	44,553	10%	$87,587	1%
$75,000 under $100,000	44,777	10%	$120,685	2%
$100,000 under $200,000	128,577	29%	$462,401	7%
$200,000 under $500,000	100,685	23%	$834,347	12%
$500,000 under $1,000,000	42,094	10%	$849,593	13%
$1,000,000 or more	48,001	11%	$4,290,281	64%

Source: IRS, Statistics of Income

Tax Foundation economists used the model to see how the Obama administration's upper-income tax proposals would affect taxpayers with business income. The three major proposals in the 2011 Obama budget include:

- Expand the 28 percent bracket and reinstate the 36 percent and 39.6 percent rates for those taxpayers with income over $250,000 (married) and $200,000 (single): Projected to raise $353.4 billion from 2011 to 2020.
- Reinstate the personal exemption phaseout and limitation on itemized deductions for those taxpayers with income over $250,000 (married) and $200,000 (single): Projected to raise $204.8 billion from 2011 to 2020.
- Impose 20-percent tax rate on capital gains and dividends for those taxpayers with income over $250,000 (married) and $200,000 (single): Projected to raise $70.4 billion from 2011 to 2020.

Together, these policy changes are estimated to raise $629 billion over 10 years from high-income taxpayers.

To isolate the effect of these changes on business income we first removed business income from these tax returns and ran them through the model to see how much Obama's tax proposals would raise in new tax revenues. We then added back the business income and ran the tax returns through the model a second time to see how much additional tax revenue would be generated.

The model determined that 39 percent of the expected new revenues generated by Obama's tax proposals would come from business income, an estimated $246 billion over ten years.

3 Department of the Treasury, Office of Public Affairs, Fact Sheet: Guidance on Section 199 – Income Attributable to Manufacturing Activities, January 19, 2005. http://www.ustreas.gov/press/releases/reports/199factsheetjs2200.pdf.

Conclusion

Supporters of the administration's proposal to raise taxes on high-income individuals try to discount the impact of these policies on private enterprise by citing the relatively small number of business owners who pay the highest tax rates. But the fact that "only" 2 or 3 percent of taxpayers with business income would face higher taxes is quite meaningless to the debate.

What is meaningful is not the number of taxpayers impacted but the amount of business income and, therefore, business activity impacted. The fact is, 74 percent of high-income taxpayers report business income and the vast majority of all private business income is generated by these high-income taxpayers. These facts explain why the Tax Foundation's Individual Microsimulation Model determined that 39 percent of the increased tax revenues generated by Obama's proposal comes from business income.

Over the past 30 years, the number of new pass-through businesses has exploded as entrepreneurs took advantage of the benefits of a single level of taxation, lower personal income tax rates, and limited liability protections. As a result, more business income is now taxed under the individual income tax code than the traditional corporate code and a majority of that income is generated by high-income taxpayers.

If the tax cuts for high-income individuals expire, much of the new revenue will be extracted from business income, an estimated $246 billion over 10 years. Despite considerable murkiness of available data, it is reasonable to assume that taxing business income by this amount will have a detrimental impact on business activity.

SPECIAL REPORT (ISSN 1068-0306) is published at least 6 times yearly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia.

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has monitored tax and fiscal activities at all levels of government since 1937.

©2010 Tax Foundation

Editor and Communications Director, Bill Ahern

Copy Editor, Alicia Hansen

Tax Foundation
National Press Building
529 14th Street, NW, Suite 420
Washington, DC 20045-1000

(202) 464-6200

www.TaxFoundation.org
TF@TaxFoundation.org