

# Business in the United States: Who Owns It, and How Much Tax Do They Pay?

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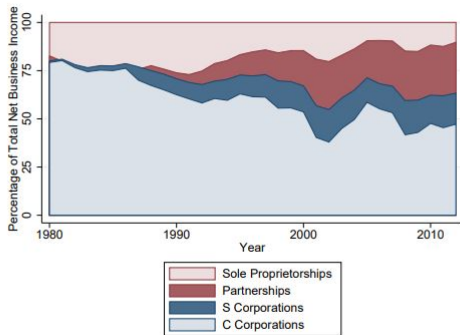
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# What is Pass-Through Business?

- ▶ US corporations may be classified into two types:
  1. C-corporations: businesses taxed at corporate income rate; owners taxed additionally on dividends
  2. Pass-Through corporations: owners taxed ONLY at individual income tax rates
- ▶ Due to various tax reforms, the number of pass-through businesses has nearly tripled since 1980, while number of traditional C-corporations has declined
- ▶ This paper studies 3 main types of pass-through businesses:
  1. Partnership - An unincorporated business with multiple owners, either individuals or other businesses
  2. S corporation - A domestic corporation that can only be owned by U.S. citizens (not other corporations or partnerships) and can only have up to 100 shareholders
  3. Sole Proprietorship - An unincorporated business owned by a single individual that reports its income on schedule C of the 1040 tax form.

# Pass-Through Businesses Have Grown Rapidly in Importance

Figure 1: Shares of Business Income by Entity Type, 1980-2010



*Notes:* This figure shows the share of overall business income by entity types from 1980 to 2012 from DeBacker and Prisinzano (2015).

- ▶ Pass-through businesses generated over half of US business income in 2011

# Outline

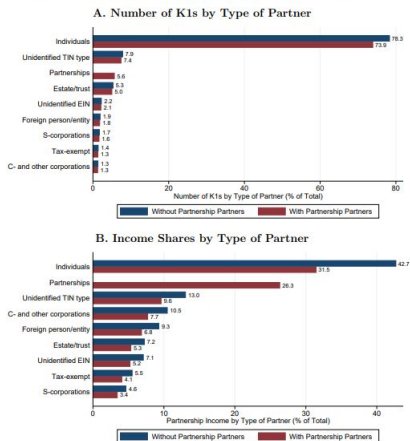
- ▶ Describe IRS data used to characterize pass-through income by
- ▶ Present Ownership Characteristics of Pass-Through Businesses Income
- ▶ Describe approach to calculate average tax rates on different types of business income for each business type
- ▶ Present 2011 average business tax estimates by corporation type (13.6% for sole proprietorships; 15.9% for partnerships; 25% for S-corporations; 31.6% for C-corporations)

## Data on Businesses and Their Owners

- ▶ Approach: Use 2011 universe of IRS corporate and individual tax returns to construct matched firm-owners data to compute industry-level partnership statistics and weighted average tax rates by income type, organizational form type, etc.
- ▶ 2011 data has 3.6 million partnerships that pay out income to 25.3 million owners, hereby referred to as "partners"
- ▶ Classify the 25.3 million partners as one of seven types: individuals; C- and other corporations; S-corporations; estates and trusts; tax-exempt organizations; foreign entities; partnerships; and un-identifiable partners
- ▶ Analogous approach used for matching S-corporations' income to owners; however, S-corp income are owned only by individuals

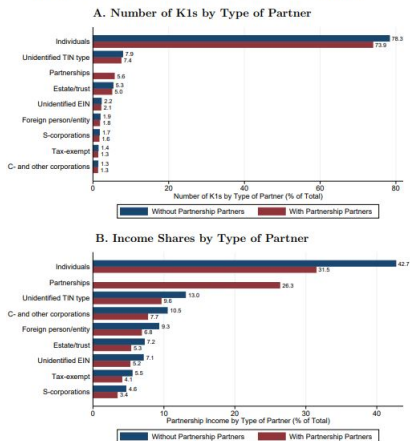
# The division of partnership income differs substantially across partner types

Figure 3: Partnership KIs and Income Shares by Type of Partner



# Partnerships themselves receive 26.3% of partnership income allocations

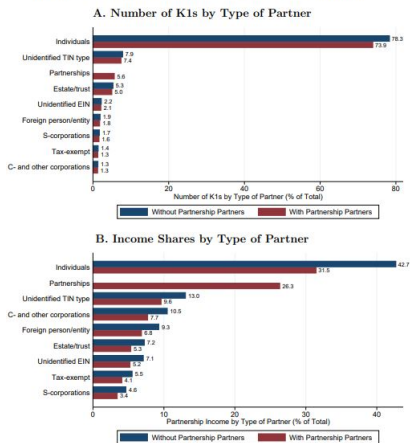
Figure 3: Partnership KIs and Income Shares by Type of Partner



► Analysis thereby must address issue of ownership tiers

# A disproportionate share of income accrues to tax-exempt and lightly taxed entities

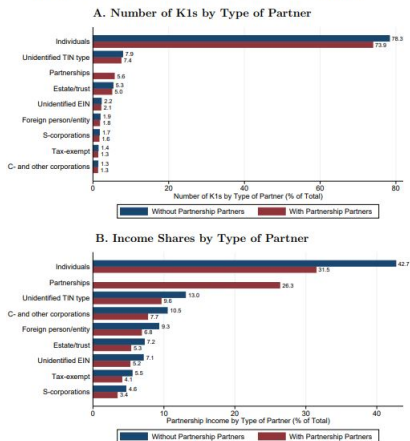
Figure 3: Partnership K1s and Income Shares by Type of Partner



- ▶ 10.9% of partnership income goes to tax-exempt and foreign partners, who comprise 3.1% of partners

# 14.8% of partnership income accrues to un-classifiable entities

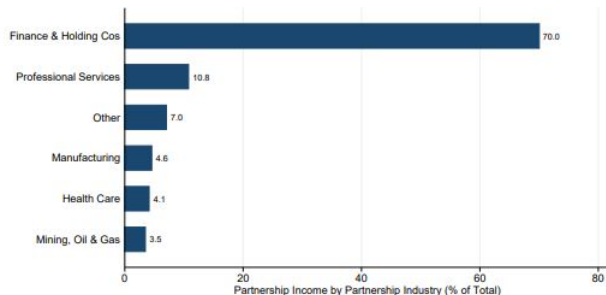
Figure 3: Partnership KIs and Income Shares by Type of Partner



► Un-classifiable income challenges estimation of tax rates

# 70% of income goes to financial firms or holding companies

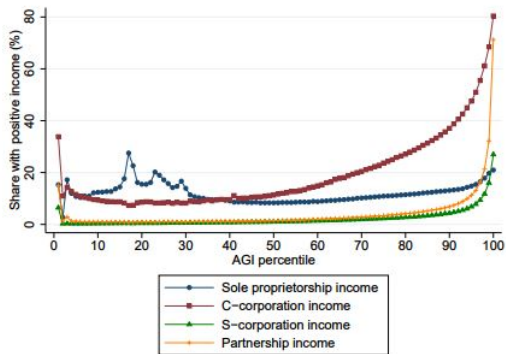
Figure 4: Distribution of Partnership Income by Industry



- ▶ Income from Finance and Holding Companies tend to be taxed at preferred rates

# Partnership Participation is high among top households, but trivial among bottom 50% households

Figure 5: Business Participation Rates by Household Income Percentile



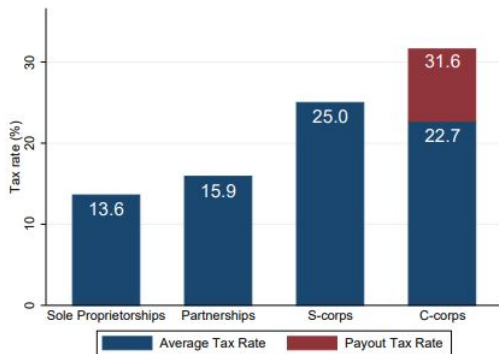
- ▶ Figure suggests that pass-through and S-corp income accounts for much of the post-1980 rise in the top -1% income share

# Methodology for Estimating Average Tax Rates

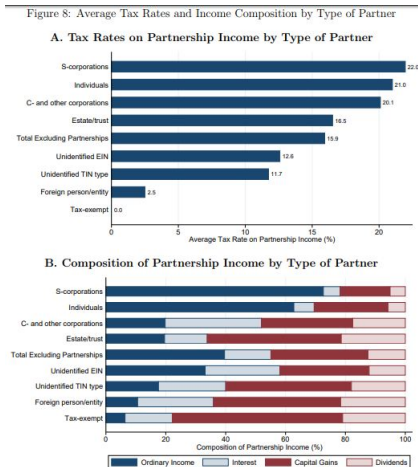
- ▶ Authors attempt to calculate a weighted average of the average tax rate for each of the 4 business sector (sole proprietorships, partnerships, S-corps, C-corps)
- ▶ Using IRS data, authors calculate average tax rate on 4 types of business income (capital gains, dividends, interest, ordinary business income)
- ▶ Attribute tax liability due to a particular business sector by taking total tax liability of the sector and subtracting off the hypothetical tax liability if sector income were zero using Office of Tax Analysis tax calculators
- ▶ Interpretation of resulting tax rates: Partnership tax rate of 15.9% means for every dollar earned by a partnership, US tax revenue rose by \$0.159

# Estimated 2011 weighted average business income tax rate is 24.3%

Figure 7: Tax Rate by Entity Type



# Capital Gains and Dividend income represent 45% of total income to nonpartnership partners

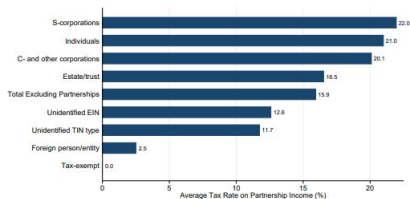


- ▶ Dividends and capital gains typically taxed at preferred rates

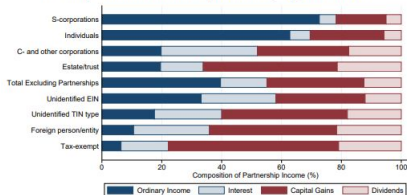
# Certain types of partners face low tax rates

Figure 8: Average Tax Rates and Income Composition by Type of Partner

## A. Tax Rates on Partnership Income by Type of Partner



## B. Composition of Partnership Income by Type of Partner



- ▶ Foreign partners, tax exempt partners, or lower-income partners face low tax rates on ALL forms of income

# Conclusion

- ▶ Pass-through business activity's quantitative importance has risen dramatically in last 30 years
- ▶ If business income shares remained at 1980s levels with the authors' estimated 2011 tax rates, then the average US tax rate on total US business income would have been 28% rather than 24%
- ▶ Key takeaway from the paper is to argue that pass-through business results in effective average tax rate much lower than top statutory personal tax rate (35%)
- ▶ Furthermore, pass-through owners are even more likely to be high-earners than owners of all other business types, including C-corporations