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Ending the Pass-Through Tax Loophole for Big Business

By Alexandra Thornton and Brendan V. Duke August 2016

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Introduction and summary

In 2012, more than 100,000 big U.S. businesses managed to shelter billions of dollars of income in a single tax haven and pay no corporate income tax on it.

This tax haven is not Panama, Switzerland, or the Cayman Islands. In fact, it cannot even be found on a map—rather, it exists in the pages of the U.S. tax code. These businesses—with revenue of more than $10 million each—managed to pay no U.S. corporate income tax by pretending to be small businesses and thus saved their wealthy owners billions of dollars.

Most people think of big businesses as traditional corporations, which are organized under Subchapter C of the tax code and are supposed to pay the corporate income tax on their profits. But today many big businesses are organized as partnerships or S corporations, which are business forms that were originally designed for simpler or smaller businesses.[1] The vast majority of partnerships and S corporations do not pay the corporate income tax. Instead, all of their income is passed through to their individual owners, who pay taxes on their individual income tax returns, thus avoiding the corporate income tax altogether.

The share of income going to businesses that use the pass-through form of organization—and therefore pay no corporate income tax—has exploded over the last 30 years, growing from less than 25 percent of net business income in 1980 to more than half in 2012.[2] In fact, the United States is unique in this regard: No other country comes close to having such a large portion of business income that is not subject to the corporate income tax.[3]

A recent groundbreaking study by economists at the U.S. Treasury Department, the University of Chicago, and University of California, Berkeley, reveals serious effects of the rise of pass-throughs on tax revenue and inequality. In principle, income from pass-through businesses could be taxed at the same rate as income from C corporations. But it is not—when one combines the corporate income tax and taxes on dividends, income from C corporations in 2011 was taxed at an effective rate of 32 percent, while income of the three general types of pass-through businesses was taxed between 14 percent and 25 percent.[4]

The study—which was based on detailed review of administrative tax data—implies that the growth of these lightly taxed pass-through businesses cost the federal government $100 billion in 2011.[5] The long-term budget impact of this revenue loss is enormous: The $100 billion revenue loss in 2011 implies as much as $790 billion in lost tax revenue from 2003 to 2012, based on nominal business income growth during that period.[6] That is $790 billion that could have been spent repairing schools, cutting taxes for everyday Americans, or reducing the national debt.[7] It is more than the $700 billion Congress allocated to bail out the financial industry in 2008 as part of the Troubled Asset Relief Program, or TARP.

What the big pass-through tax loophole and TARP have in common is that both heavily benefit the financial industry: 70 percent of partnership income—the primary business form that big businesses use to avoid corporate taxes—goes to the financial industry and holding companies.[8]

The major differences between the big pass-through loophole and TARP, however, are that TARP ended up only costing $28 billion and helped prevent the next Great Depression.[9] The tax revenue lost from hedge funds, private equity firms, other financial firms, and holding companies pretending to be small businesses, on the other hand, is gone forever from federal revenues and only benefitted the mostly wealthy owners of private businesses.

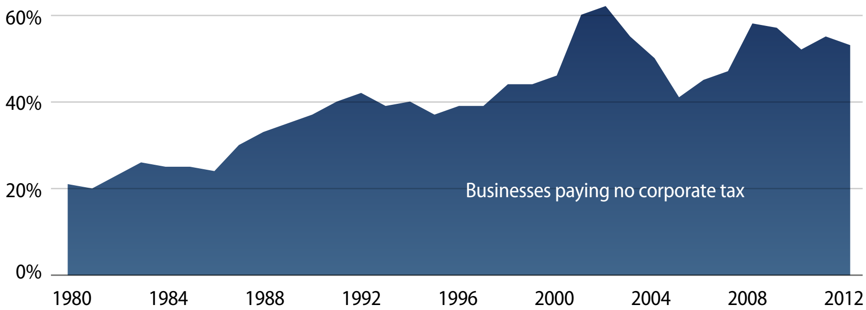
The lower tax rates on income from pass-throughs are often defended based on the assumptions that all small businesses are pass-throughs and that all pass-throughs are small businesses. Both assumptions are wrong. In fact, the growing number of pass-through entities has very little to do with small business. Indeed, several of the largest U.S. hedge funds are taxed as partnerships.[10] In part because increasing numbers of businesses are adopting pass-through forms, the corporate income tax today contributes only about one-tenth of total tax revenues compared to one-third 60 years ago.[11]

The ability of big businesses to avoid paying the corporate income tax through organizing as pass-through entities represents an enormous loophole in the country's business taxation regime that the original designers of the corporate

FIGURE 1

Most business income is no longer subject to the corporate tax

Share of net business income going to pass-through businesses



Source: Michael Cooper and others, *Business in the United States: Who Owns It and How Much Tax Do They Pay?* (Cambridge: National Bureau of Economic Research, forthcoming), data available at http://faculty.chicagobooth.edu/owen.zidar/research/data/tpe/-Business_in_the_US_-_Data.xlsx.

income tax probably never foresaw. Three facts underscore just how thoroughly big business, the financial industry, and the wealthy have exploited tax rules that were originally designed for smaller, simpler businesses:

- Seventy percent of partnership and S corporation revenue goes to big businesses.[12]

- Seventy percent of partnership income comes from the financial industry and holding companies.

- Seventy percent of partnership and S corporation income goes to the top 1 percent of U.S. households by income.[13]

Until recently most analyses of income inequality, such as that by Thomas Piketty in *Capital in the 21st Century*, have ignored the role of pass-through income in the U.S. tax system by allocating it according to a standard economic formula. But, as this report will highlight, it is impossible to understand the growth of income inequality without a deeper look at pass-through income: about 40 percent of the increased share of income going to the top 1 percent of households is explained by pass-through income—twice the contribution of other forms of capital, such as corporate stocks and bonds.[14]

Policymakers and the media have shined a bright light on how U.S. multinational corporations' use of foreign tax havens has caused corporate tax revenue to decline.[15] Yet the problem of the growing number of large U.S. businesses that are not required to pay the corporate income tax at all has received far less attention. The U.S. Congressional Budget Office, or CBO, recently estimated that about half of the projected decline in corporate income tax revenue in recent years is a result of C corporations transforming to pass-through entities and thereby no longer paying any corporate income tax at all.[16]

This report explains the reasons for the rise of pass-through businesses, especially partnerships, showing how this form of business organization facilitates tax avoidance and opaque business practices. It also highlights new data, referenced above, showing the role of pass-throughs in the growth of income inequality and the likely cost to American taxpayers. Finally, the report identifies options to address these concerns as part of corporate tax reform and highlights three actions policymakers can take to prevent big business from hiding in the pass-through tax haven.

1. **Make large pass-through entities pay an entity-level tax like C corporations do.** This could take many forms including taxing the relatively small number of pass-through firms that meet certain size thresholds based on level of profits, gross receipts, or assets. This would target less than 2 percent of pass-through firms—but a large share of pass-through income—while not affecting truly small and moderate-sized businesses.

2. **Make sure wealthy taxpayers pay their fair share of tax on pass-through income at the individual level.** This income should be subject either to employment taxes or the net investment income tax, whichever is appropriate, but should not escape both.

3. **Help truly small businesses.** If business tax breaks are eliminated as part of a future corporate tax reform effort, more targeted relief could be provided to actual small businesses which would not benefit from a reduction in the corporate tax rate.

Policymakers must enact reforms to curb the extent to which very large companies can use pass-through forms of organization. Businesses should be able to organize however they want in order to run their operations as efficiently as possible. But the arguments in favor of pass-through taxation for some types of businesses, especially partnerships, become very weak when these entities are huge businesses that use this organizational form to avoid paying billions of dollars in taxes—businesses that would be taxed as corporations if not for the big pass-through loophole.

Background

The United States first introduced a direct tax on the income of corporations early in the 20th century to prevent corporations from becoming tax havens.[17] Without a corporate income tax, owners of corporate stock could retain their share of untaxed business profits in the corporation indefinitely and thereby avoid the individual, or personal, income tax.[18] In this manner, the rich could accumulate wealth much faster than the rest of the population, who largely pay individual income tax on all of their income in the year it is earned. With the introduction of the corporate income tax, the United States curbed this source of wealth accumulation for the very rich, but also enabled the government to raise revenue from foreign investors in U.S. corporations and foreign corporations that have U.S. income—groups that the United States might not otherwise be able to tax.[19]

When a corporation distributes dividends to its shareholders, those shareholders include the dividends on their personal tax returns. Dividends are currently taxed at about half the rate of tax on ordinary income, such as wages and salaries; a large share of dividends are not taxed at all on the shareholder level because more than three-quarters of U.S. corporate stock is held in nontaxable accounts.[20]

However, only corporations organized under Subchapter C of the U.S. Internal Revenue Code, or C corporations, pay the corporate income tax. Other types of businesses—S corporations, partnerships, and sole proprietorships—are not required to pay any income tax at the entity level.[21] Rather, all of their net income is passed through to their ultimate owners who each pay individual income tax on their proportionate share of the pass-through business's income. Thus, the pass-through business pays no corporate income tax at all. Moreover, owners of pass-through businesses often pay the much lower capital gains tax rate on much of their pass-through income, rather than the ordinary income tax rate.

Businesses can choose to organize as a C corporation or as one of the pass-through forms of organization, which include sole proprietorships, S corporations and partnerships, as well as limited liability corporations, or LLCs, which are taxed like partnerships. Sole proprietorships are unincorporated businesses with only one owner. Thus, while not technically limited in asset size, they are not attractive to large businesses that require the capital of many owners. S corporations, by contrast, can have up to 100 shareholders today, and partnerships may have an unlimited number of partners.

The striking rise of pass-throughs and its causes

In 1980, C corporations made up about 79 percent of total business income, and sole proprietorships made up about 17 percent.[22] Thus, the income of S corporations and partnerships together represented only about 3 percent of business income. By 2012, partnership and S corporation income had grown to such an extent that it made up 40 percent of all business income.[23] When income from sole proprietorships is included, more than half of business income today faces no tax at the company level.[24]

This section explores three reasons for the rise of pass-through income at the expense of C corporation income: the shift from producing goods to producing services; lower effective tax rates for pass-throughs; and the rise of limited liability companies.

Business sector shifts

One reason offered for the decline of C corporations is the shift in U.S. business from producing goods to producing services.[25] Industries that produce goods generally require more capital than those that produce services and thus may need to raise large amounts of money from the stock market—something only C corporations can do. Indeed, C corporations receive 69 percent of business receipts in the goods-producing sector, but only 58 percent in the services sector.[26] However, this sector shift has played a minor role in the rise of pass-throughs, explaining just about 10 percent of their increase.[27] The reason sector shifts have played such a small role is that the shift toward pass-throughs has occurred in every industry.[28]

Lower individual income taxes

The most obvious reason why big businesses increasingly organize themselves as partnerships and S corporations is to lower their taxes. A recent study by several economists—Michael Cooper, John, McClelland, James Pearce, Richard Prisinzano, Joseph Sullivan, Danny Yagan, Owen Zidar and Eric Zwick of the U.S. Treasury Department, University of California, Berkeley, and the University of Chicago—sheds new light on just how much lower taxes are on income from pass-throughs than on income from C-corporations.

Debates about business tax rates often focus on the corporate tax rate stated in the tax statute, which is 35 percent for C corporations. But corporations rarely pay the full statutory rate—instead, it is more useful to look at their average effective tax rate, which roughly speaking is the tax rate paid when deductions, credits, and other subsidies are taken into account.[29] The average effective tax rate that corporations pay is 23 percent.[30]

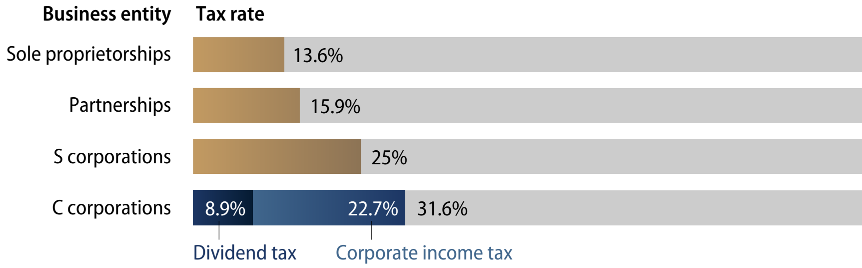
While it is certainly not high, the average effective tax rate on C corporations is nevertheless higher than that on pass-throughs. In 2011, the average effective tax rate on income from C corporations—combining both the tax on corporate income and the tax owners pay on their dividends—was 32 percent, as opposed to 25 percent and less than 16 percent for income from S corporations and partnerships, respectively.[31] The above estimates of tax rates are based on 2011 tax rates, which likely have changed with the 2013 tax rate increases. But the disparity in tax rates continues: In 2015 the effective marginal tax rate on new investment by C corporations was 30 percent and by pass-through businesses was 25 percent.[32]

The reality is that the Tax Reform Act of 1986, or TRA'86, set the stage for the pass-through explosion by reducing the top statutory marginal income tax rate for individuals from 50 percent to 28 percent by 1988, while only lowering the statutory corporate income tax rate from 46 percent to 34 percent in 1988.[33] When combined with the normal tax treatment of corporate profits, the very low individual tax rate under TRA'86 gave companies a strong incentive to become pass-through entities. Although TRA'86 put restrictions on the use of pass-through businesses as tax shelters, the share of business income generated by pass-throughs grew from 24 percent to 33 percent just two years after the law's enactment.[34] And, although the tax rates have increased somewhat on top individual incomes and on capital gains and dividends since then, the disparity in average effective tax rates between C corporations and pass-through entities persists today.[35]

FIGURE 2

Pass-through businesses pay much lower taxes than C corporations

Average effective tax rate by type of business entity



Source: Michael Cooper and others, *Business in the United States: Who Owns It and How Much Tax Do They Pay?* (Cambridge: National Bureau of Economic Research, forthcoming), data available at http://faculty.chicagobooth.edu/owen.zidar/research/data/tpe/-Business_in_the_US_-_Data.xlsx.

LLCs: A new form of partnership

Of all the different types of pass-through entities, partnerships have grown the most, likely because they face fewer restrictions than S corporations, which can only have 100 owners who must all be U.S. citizens or residents. Partnerships offer much greater flexibility both in the types of entities that can be partners and in the rules governing apportionment of income and expenses.[36]

Partnerships, however, initially came with a huge disadvantage—they lacked limited liability, unlike C or S corporations. Traditionally, partnerships were required to have one or more general partners who were personally liable for a partnership's debts beyond their equity stake—if a general partner owned 25 percent of a company valued at $1 million and the company went bankrupt with debts of $3 million, the general partner would not only lose his or her $250,000 equity stake but would be personally liable for an additional $500,000 of debt, representing 25 percent of the $2 million of remaining debt.[37] Owners would thus have to choose between the tax benefits of organizing as a partnership and the personal financial risk of forgoing limited liability.

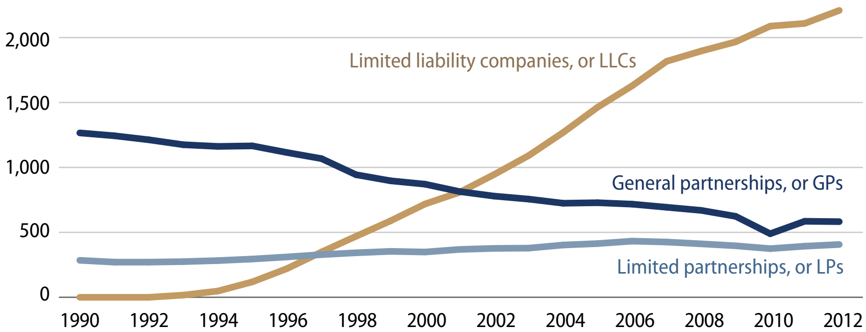
Legal and regulatory changes in the late 1980s and 1990s, however, allowed business owners to enjoy the best of both worlds. During that period, a growing number of states passed laws permitting the formation of what are termed limited liability companies—effectively partnerships that enjoyed limited liability.[38] The U.S. Treasury formally blessed this arrangement in 1996 with the release of new rules permitting unincorporated entities such as LLCs to check a box to be treated as a pass-through entity for tax purposes.[39] This allowed companies to reap the main benefit of corporate status—limited liability—along with the main benefit of partnership status: low effective tax rates.

Businesses have responded enthusiastically, and almost two-thirds of partnerships are LLCs today.[40] Meanwhile, the number of other types of partnerships—general partnerships and limited partnerships—has slowly declined.[41]

FIGURE 3

Limited liability companies are by far the most popular type of partnership today

Domestic partnership returns by type of partnership, 1990–2012



Source: Authors' analysis adapted from U.S. Congress Joint Committee on Taxation, "Choice of Business Entity: Present Law and Data Relating to C Corporations, Partnerships, and S Corporations" (2015), Table 6, available at https://www.jct.gov/publications.html?func=startdown&id=4765.

Domestic tax havens for big business, Wall Street, and the top 1 percent

Today, a majority of business income is not taxed at the entity or company level. This income is thus taxed at a lower effective tax rate compared to C corporation income, when individual income taxes on C corporation dividends are taken into account. This raises important questions about what kinds of businesses are pass-throughs and who are their owners. Policymakers often justify the lower effective tax rates for partnerships and S corporations as a way to help small business. There is some evidence that small businesses help job creation, innovation, and economic mobility, although the merits of specific policies to help small businesses can be debated.[42]

Lower taxes for pass-throughs could potentially be justified if most of their income went to innovative economic sectors or middle-class business owners. Examining the data, however, it becomes clear that pass-throughs—and partnerships in particular—are dominated by big business, the financial industry and holding companies, and the top 1 percent.

Pass-throughs are not necessarily small businesses

Traditionally, policymakers have characterized C corporations as big business and the other three types of business entities—sole proprietorships, S corporations, and partnerships—as small business.[43] For example, in a 2015 interview about tax reform conducted by a Wisconsin think tank, House Speaker Paul Ryan (R-WI) said, "You can't leave small business or what we call 'pass-throughs' out of this first round of tax reform. You've got to have an answer for most of the small businesses in America who file their taxes as individuals."[44] Indeed, the tax code defines an S corporation as a "small business corporation."[45]

Fact

70 percent of partnership and S corporation receipts go to big businesses.

A deeper look, however, reveals how misleading this perception is. Using data from Congress's Joint Committee on Taxation, or JCT, the authors of this report define a small business as a business that has less than $10 million in annual receipts—a definition that includes 99.4 percent of all U.S. businesses.[46] Looking just at partnerships and S corporations, indeed the vast majority are small businesses according to this definition—98.9 percent and 97.8 percent, respectively. And it turns out that this definition also holds true for the vast majority of C corporations: More than 95 percent of these businesses have annual receipts of less than $10 million, despite the perception that C corporations are all big businesses as noted above.[47]

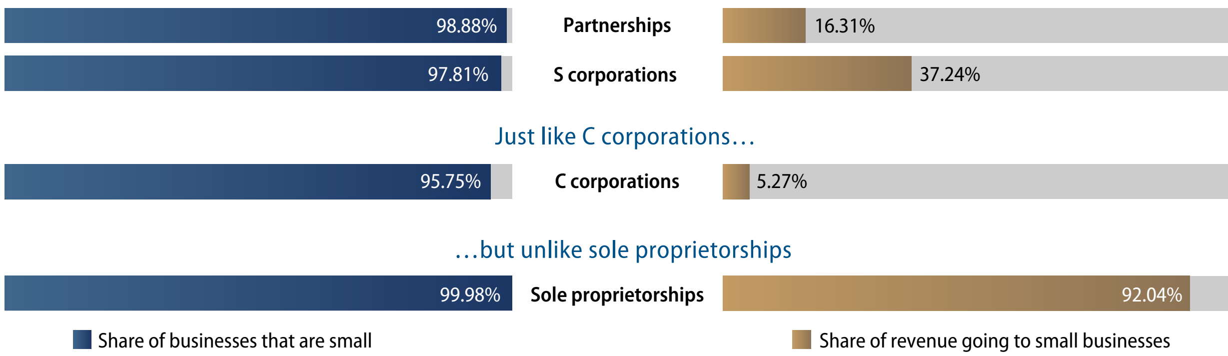
But to say that most pass-throughs are small ignores the fact that the remaining pass-throughs—less than 3 percent of S corporations and partnerships—are huge. The relevant question for tax policy is not how many partnerships and S corporations are small businesses, but rather what percentage of partnership and S corporation income goes to small businesses. Unfortunately, the JCT data do not allow for a direct examination of income, but the data do show the share of revenue—income before subtracting expenses—going to small businesses by legal form. The JCT data show that less than 40 percent of S corporation and 20 percent of partnership revenue goes to small businesses.[48]

Altogether, more than 70 percent of partnership and S corporation revenue goes to big business. This is far closer to the share of C corporation revenue that goes to big business—94 percent—than it is to the share of sole proprietorship revenue that goes to big business—8 percent.[49] Clearly, lower tax rates for all pass-throughs, as proposed by many conservatives, would provide the greatest economic benefit to big businesses. This is especially true in the case of a reduction in the top tax rate because the majority of taxpayers who receive pass-through business income—92 percent by one estimate—are already in the 25 percent tax bracket or lower.[50] A policy aimed at small businesses that reduces the top tax rate for all pass-throughs would mostly be a gift to these huge pass-through businesses.

Indeed, while pass-through business forms were intended for simpler business organizations, big pass-throughs are anything but simple. This is partly because the pass-through rules do not limit the asset size or revenue of S corporations and partnerships. In addition, while there are other restrictions on S corporations—for example, S corporations are limited to 100 shareholders—the flexible rules for partnerships enable them to be very complex organizations both structurally and geographically. For instance, partners in a partnership are not limited to individuals—they can also be corporations, other partnerships, tax-exempt organizations, or all of the above.[51] In fact, many big partnerships have multiple tiers of partnerships, with some partners located in foreign jurisdictions, making them difficult for the IRS to track.[52] One study found that nearly 40 percent of all partners come from less than 1 percent of partnerships, showing that the small number of very large partnerships account for well more than a third of partners.[53] Some of these partnerships issue more than 100,000 K-1s—an annual form that is filed for each partner—making an audit by the IRS nearly impossible, especially when some of those partners are other partnerships with many partners of their own.[54] This lack of transparency of large partnerships has become a global concern, as authorities are finding that it provides the foundation not only for tax avoidance but also for funding of criminal activities.[55]

FIGURE 4

Most partnerships and S corporations are small, but most revenue goes to big businesses



Note: "Small business" is defined as a business with less than $10 million in receipts annually.

Source: Authors' analysis using U.S. Congress Joint Committee on Taxation, "Choice of Business Entity: Present Law and Data Relating to C Corporations, Partnerships, and S Corporations" (2015), available at https://www.jct.gov/publications.html?func=startdown&id=4765.

Partnerships: A tax avoidance tool preferred by Wall Street

When most Americans think of partnerships, they think of upper-middle-class professionals, such as lawyers and doctors. The recent study by Cooper and his coauthors, however, shows that the industries employing lawyers and doctors received only 11 percent and 4 percent of partnership income, respectively.[56] Instead, the study found that 70 percent of partnership income went to the financial industry, including banks, hedge funds, and private equity firms, and holding companies.[57]

Fact

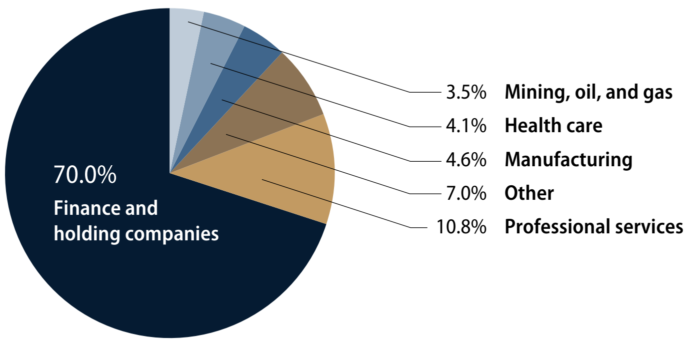
70 percent of partnership income went to Wall Street and holding companies in 2011.

Strikingly, financial industry and holding company partnerships had the lowest average tax rate of any major partnership industry sector. While partnership income in the industries that employ doctors and lawyers is taxed at a low 22 percent average tax rate, this is still far higher than the 15 percent average tax rate paid on partnership income in the financial industry and holding company sector.[58] One reason for the lower average tax rate for financial industry and holding company partnership income is that most of it comes in the form of capital gains and dividends, which are taxed at much lower rates than ordinary income. Well over 90 percent of health and professional service partnership income, on the other hand, is taxed as ordinary income.[59] The carried interest loophole, which is used by the private equity industry and has received a lot of attention during the 2016 presidential campaign from conservative and progressive candidates alike, is one way that pass-through businesses can re-characterize ordinary income as investment income in order to take advantage of the lower tax rate on capital gains.

FIGURE 5

Most partnership income goes to finance and holding companies

Distribution of partnership income by industry



Source: Michael Cooper and others, *Business in the United States: Who Owns It and How Much Tax Do They Pay?* (Cambridge: National Bureau of Economic Research, forthcoming), data available at http://faculty.chicagobooth.edu/owen.zidar/research/data/tpe/-Business_in_the_US_-_Data.xlsx.

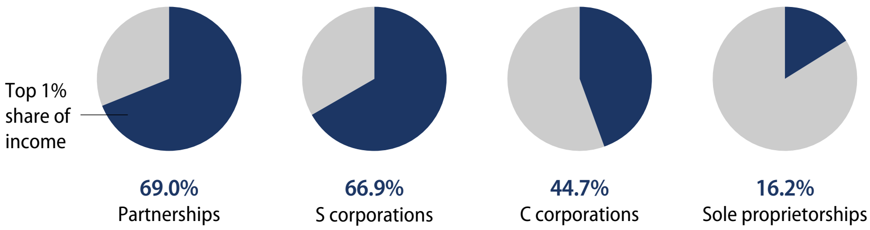
Pass-through income has helped drive the recent growth in inequality

Given that the financial industry and holding company sectors receive the majority of partnership income, it is not surprising that 70 percent of partnership income goes to the top 1 percent of households, while just 13 percent goes to the bottom 90 percent of households.[60] These numbers are practically identical for S corporations. This makes even the skewed distribution of C corporation income look relatively equal by comparison: only 45 percent of C corporation income goes to the top 1 percent of households.[61]

FIGURE 6

Partnership and S corporation income is more unequal than C corporation income

Share of income going to the top 1 percent of households by business entity type



Source: Michael Cooper and others, *Business in the United States: Who Owns It and How Much Tax Do They Pay?* (Cambridge: National Bureau of Economic Research, forthcoming), data available at http://faculty.chicagobooth.edu/owen.zidar/research/data/tpe/-Business_in_the_US_-_Data.xlsx.

Not only is the distribution of pass-through income highly skewed to the top, but the evidence also increasingly suggests that it has played a central role in the growth of income inequality. Economists typically divide national income into two categories: capital income—which comes from holding assets that provide income, such as stocks or bonds—and labor income, which is paid to workers in wages, salaries, bonuses, and other compensation.[62] Pass-through income is a mix of these two categories: Many partners and owner-shareholders are not entirely passive investors but actively engage in some aspect of running the business. Traditionally, economic analyses of inequality have not focused on the role of pass-through income, instead allocating it to capital and labor according to standard formulas.

The distribution of income between labor and capital plays a critical role in French economist Thomas Piketty's bestseller *Capital in the 21st Century*, in which he describes two ways capital income can cause income inequality to explode. First,

Fact

70 percent of partnership income went to the top 1 percent in 2011.

if the distribution of capital income—in other words, who owns capital income—becomes more unequal, and second, if the percentage of national or total income going to capital rises.[63] Since capital income already is distributed very unequally, the second situation—an increase in capital income—has the potential to alter the income distribution dramatically.[64]

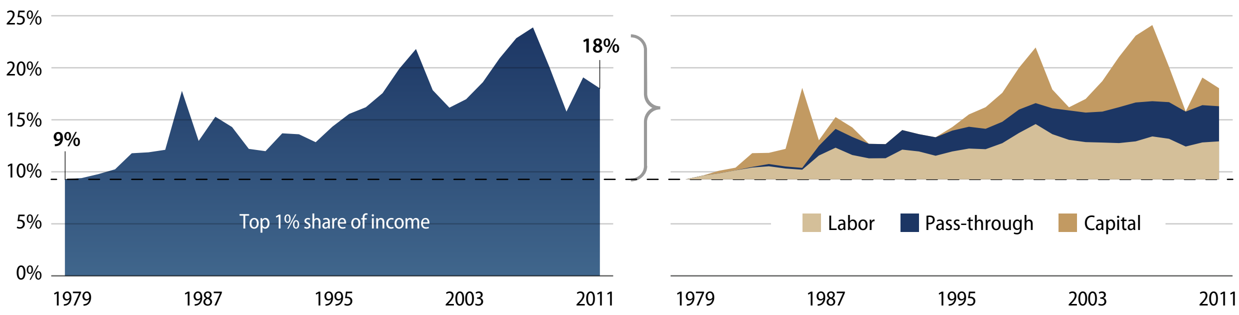
Piketty, however, misses the unique role of pass-through income in the United States, allocating it to labor and capital based on their share of income for the rest of the economy rather than analyzing pass-through income separately.[65] This approach may make sense for his international analysis, but it obscures key U.S. tax issues. Tax experts have struggled for years with the challenge of determining what portion of business income is actually labor income subject to ordinary income tax rates and what portion is a return on investment or capital income, which is taxed at about half the rate at which ordinary income is taxed. Indeed, wealthy taxpayers have notoriously taken advantage of this problem by finding clever ways to re-characterize some of their ordinary income as capital income and thus take advantage of the much lower tax rate on capital income.

While the ability to turn ordinary income into capital income is difficult to prove, this pernicious aspect of pass-through taxation may help explain why an increasing share of income of the wealthy takes the form of pass-through income. The recent analysis by Cooper and his coauthors shows that around 40 percent of the increase in the share of income going to the top 1 percent is explained by pass-through income.[66] Piketty's prediction appears to be coming true in the United States, except it is not the classic sources of capital income that are driving the growth of inequality, but rather pass-through income. Using a different income dataset that has some advantages over that used by Cooper and his coauthors, this report verifies that result and finds that 38 percent of the growth of the top 1 percent's share of market income is explained by pass-through income, that is, income from business that is passed through to the individual shareholders' or partners' tax returns.[67] This is almost double the share explained by individuals' capital income that does not come from pass-through businesses.

FIGURE 7

Pass-through income has driven the growth of income inequality

Sources of the top 1 percent's growing share of market income



Note: Analysis is of families with children as a rough aging control.

Source: Authors' analysis of Congressional Budget Office, "The Distribution of Household Income and Federal Taxes, 2011" (2014), available at https://www.cbo.gov/publication/49440.

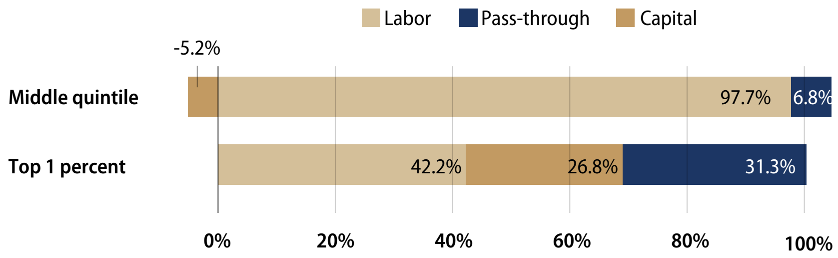
Like regular capital income, there are two ways pass-through income can increase income inequality: its share of total household income can grow or its distribution can grow more unequal, with a larger portion going to households with higher incomes. Both outcomes have taken place over the last 40 years. During that time, pass-through income has gone from taking up 5.2 percent of total household income to 9 percent.[68] At the same time the share of pass-through income received by the top 1 percent has grown from 21 percent to 49 percent.[69] By comparison, the share of household income accruing from other sources of capital income did not grow over the period and the share of other sources of capital income received by the top 1 percent grew less rapidly.[70]

Unsurprisingly, the middle class has not participated in this explosion of pass-through income. Between 1979 and 2011, the real market incomes of families in the middle quintile grew 19.6 percent or 0.6 percent per year.[71] Pass-through income accounts for just 7 percent of 1979-2011 middle-class income growth—the vast majority of middle-class income growth during that period came from traditional labor. Over the same time period, the real market incomes of the top 1 percent have grown a whopping 197 percent or 3.5 percent per year.[72] Pass-through income accounts for almost one-third of that growth.

FIGURE 8

The rise of pass-throughs has not helped the middle class

Sources of market income growth, 1979–2011



Note: Analysis is of families with children as a rough aging control.

Source: Authors' analysis of Congressional Budget Office, "The Distribution of Household Income and Federal Taxes, 2011" (2014), available at https://www.cbo.gov/publication/49440.

The resulting loss of federal revenues

The recent analysis by Cooper and his coauthors suggests that the rise of large pass-through entities reduced federal revenue by $100 billion in 2011 based on a few strong but straightforward assumptions. This is even more than a similar estimate from an earlier study by the Congressional Budget Office finding that the revenue lost from pass-throughs in 2007 was $76 billion.[73] If the $100 billion number is representative of the entire 2003 to 2012 period that could represent a total loss of federal revenue of $790 billion.[74]

This is a shocking amount of lost revenue for a tax break that mostly goes to financial and holding company entities. In 2008, Americans were aghast when Congress authorized $700 billion in taxpayer money for the TARP program, which also heavily benefited the financial industry. The difference, of course, was that the TARP program helped save the economy and actually only ended up costing the U.S. Treasury $28 billion.[75] The loss of revenue from lightly taxing financial firms, on the other hand, is gone forever from federal revenues and only served to make wealthy people richer.

The lost revenue from the rise of pass-throughs could potentially be justified if it delivered a vibrant small-business sector that produced innovation, opportunity, and millions of new jobs. Indeed, some of this revenue loss may actually go to new small businesses. But it is clear that most of this lost revenue goes to big businesses and the top 1 percent. Addressing the issue of large pass-throughs represents a ripe opportunity for tax reform that will not only make the economy more efficient by eliminating a tax distortion but will also make the tax system more equitable.

What can be done?

Shockingly, many conservative tax proposals would actually make the pass-through loophole worse. Conservatives frequently say that, if the corporate tax rate is lowered, tax rates on pass-through income should be lowered, too.[76] Such statements fly in the face of the clear evidence that an alarmingly high and growing number of very large businesses are choosing to organize as pass-through entities precisely because the effective tax rates are already lower.[77] The playing field is already heavily weighted in favor of these businesses and their wealthy owners; in fact, if the corporate tax base were broadened by eliminating many business tax breaks and only corporate tax rates were lowered, it is likely that the effective tax rate on corporations would still be higher in general and for most assets than effective tax rates on pass-through business income.[78]

Lowering top individual tax rates to cut taxes on pass-through income would lose large amounts of revenue while further increasing after-tax inequality since it would reduce taxes on all personal income in the top brackets, not just pass-through business income.[79] In addition, lowering the top individual rates would not benefit most small businesses, because the overwhelming majority of small businesses are in the 25 percent individual income tax bracket or lower.[80] And attempting to lower the rate just on business income of individuals and not on other individual income would be difficult to administer because of the difficulty of distinguishing how much of a business person's income is personal and how much is business-related. This approach would most likely encourage even more inefficiencies as taxpayers tried to re-characterize ordinary income as business-related income.[81]

In short, providing large pass-through businesses with an additional tax cut would only exacerbate the unequal playing field that exists between big pass-throughs and similarly-sized corporations, particularly within the same business sector. Furthermore, it would result in the substantial loss of federal revenue associated with pass-through income and ultimately increase income inequality.

For decades, many highly-respected tax theorists have struggled with an appropriate way to reform the tax code so that corporate profits are only taxed once—an approach commonly referred to as corporate integration.[82] The potential problems with this approach are overwhelming and include huge losses of tax receipts, exacerbation of inequality in the tax code, and complex transition issues, not to mention serious political obstacles. The fact remains that the corporate income tax is a critical backstop to the individual income tax, ensuring that the wealthy and foreigners doing business in the United States contribute their fair share to the cost of making the U.S. economy the strongest in the world.

Moreover, the so-called double tax burden on corporate profits is often exaggerated. For example, debt-financed corporate income is not taxed at the entity level due to the deductibility of interest, and some corporate shareholders are tax exempt so profits distributed to them are only taxed once.[83] In fact, a recent analysis by Steven Rosenthal and Lydia Austin at the Tax Policy Center concludes that the share of U.S. corporate stock held in taxable accounts fell more than two-thirds over the last 50 years to approximately 24 percent in 2015.[84] And, of course, individuals pay a substantially reduced tax rate on capital gain and dividend income.[85]

So long as the United States has a corporate income tax, the use of pass-through organizations by very large businesses to avoid the corporate income tax should be considered yet another corporate tax loophole to be closed as part of corporate tax reform. If accomplished as part of corporate tax reform, policymakers could choose to use the additional revenue to send more young people to college without debt, to invest in infrastructure, or as part of a compromise with conservatives to reduce the overall corporate tax rate. Meanwhile, this serious source of leakage in corporate tax revenues would be stopped and help provide the certainty of federal revenue streams needed to better manage tax reform and the nation's long-term debt. Moreover, it is possible to protect small businesses and innovation without giving yet another handout to large businesses that should be paying tax at the entity level.[86]

Recommendations

Numerous proposals have been advanced to address the revenue loss from the use of pass-through organizational forms by big businesses.[87] It is imperative that Congress take steps to ensure that these businesses pay their fair share of tax. Specifically, lawmakers should take the following steps.

Make large pass-through businesses pay tax like C corporations do

Throughout the more than 100-year history of the tax code, Congress has acted to shore up the system when major leakage has developed. Doing so not only ensures stable revenues to fund important public services but also maintains fairness in the tax system as a whole. In fact, long-term erosion of the tax base was on Congress's mind when it enacted legislation in 1987 to treat publicly traded partnerships as C corporations for tax purposes.[88] It is hard to see how today's revenue leakage brought about by the rapid rise of large nonpublicly traded pass-through entities is any different.

Some large pass-throughs have more partners than many C corporations have shareholders. In fact, since most of the partners are not actively engaged in the business, they are effectively shareholders, and the income that the partnership distributes to them looks more like dividends. More important than the number of partners is the fact that increasing numbers of those partners are entities other than individual people, which creates multiple tiers of individuals, partnerships, corporations, and other organizations. When partners in a huge private partnership number in the thousands and consist of so many different kinds of entities, the rationale for treating the partnership as a pass-through entity ceases to have meaning.

It has been exceedingly difficult, if not impossible, for the IRS to audit these very large, complex partnerships. For this reason, the Bipartisan Budget Act of 2015, or BBA, attempted to streamline the procedures for auditing large partnerships. Under the provisions of that legislation, any adjustments in tax liability as a result of the audit will be made at the partnership level, and the partnership will be responsible for either paying any shortfall or seeking information and amended returns from the individual partners, rather than requiring the IRS to pursue each partner individually for its ratable share of the adjustment.[89] The BBA defined large partnership for this purpose as those with more than 100 partners, which, interestingly, is similar to the limitation on the number of shareholders in an S corporation.[90]

Congress could take the next step and require these entities to pay a separate entity-level tax, without necessarily requiring them to alter their organizational form if they choose to keep it for other reasons. At a minimum, this action would make up for the revenue loss and tax gap associated with the alarming growth in large pass-throughs. Equally important, such a tax would broaden the corporate tax base. According to one estimate, corporations effectively are paying an additional 3 percentage points higher tax rate to make up for the huge revenue loss from allowing large pass-throughs to avoid the corporate level of tax.[91]

Taxing large pass-throughs at the entity level would not affect the vast majority of pass-throughs since most are small businesses. A 2012 Congressional Research Service, or CRS, analysis estimated that imposing the entity-level tax on pass-through firms with more than $10 million in gross receipts, for example, would affect only 1.1 percent of partnerships and less than 2 percent of S corporations.[92] In his fiscal year 2017 budget, President Barack Obama proposed the creation of a uniform small business threshold for accounting purposes—$25 million in average annual gross receipts.[93] The same threshold could be used for entity-level taxation. Another possible approach would be to determine size based on assets. The 2012 CRS analysis found that a threshold of $50 million in assets would affect 0.2 percent of S corporations and 1 percent of partnerships.[94]

The idea of requiring large pass-throughs to pay the corporate income tax has received some criticism. For example, a size threshold for application of the corporate income tax might lead to uncertainty from year to year for some businesses that are close to the threshold.[95] This problem, however, could likely be addressed through proper design of the rules or by only taxing net income above a certain level.

The possibility that some firms might attempt to manipulate the rules by splitting their operations into separate entities to avoid passing the threshold is another concern.[96] However, this seems less likely where the threshold is set fairly low.

Additionally, anti-abuse rules could be drafted to identify these situations. Finally, if big pass-throughs were taxed at the entity level as part of a larger corporate tax reform where the corporate tax rate was lowered, big pass-throughs might opt to become C corporations instead.

It is possible that some big pass-throughs would attempt to shift income offshore, but that is just a mirror of what already is happening with multinational corporations. Presumably both practices would be addressed as part of overall corporate tax reform. In addition, the potential for new transparency rules aimed at identifying beneficial owners of companies and similar measures would be helpful in preventing inappropriate income shifting.[97]

Because higher-income taxpayers would generally bear most of the burden of taxing big pass-throughs at the corporate level and have limited options for shifting that tax burden onto lower-income taxpayers, this recommendation could go a long way toward reducing after-tax income inequality.

Make sure wealthy taxpayers with business income pay their fair share, just like working families do

In addition to taxing big pass-throughs at the entity level, policymakers should make sure that all wealthy individuals who receive business-related income pay the appropriate amount of employment and net investment taxes on that business income. Currently, many members of LLCs, in particular, are receiving a double tax break on their business income from the LLC: they avoid both the corporate-level tax and the 3.8 percent net investment income tax that is supposed to help fund Medicare.

President Obama has proposed an approach in which all pass-through income that is not otherwise subject to employment taxes at the individual income tax level would be subject to the 3.8 percent net investment income tax, which is imposed on net investment income above $250,000 for joint returns.[98] This approach makes sense both as a simplification measure and to make the tax treatment of pass-through income more rational. All pass-through income should be considered either ordinary income, subject to both individual income and payroll taxes, or capital income, such as gains on investments in stocks and other financial products, subject to capital gains tax and the net investment income tax.

Help truly small businesses

If policy makers wish to help truly small businesses, there are a number of ways to provide more targeted relief than a tax rate reduction for all pass-through businesses.

As part of the Protecting Americans from Tax Hikes Act of 2015, Congress permanently extended a temporary expansion of Section 179, which allowed firms to expense, or deduct immediately, up to $500,000 of the cost of equipment purchases.[99] The deduction is phased out completely for equipment costing $2.5 million or more. Allowing businesses to expense the cost of equipment purchases relieves some of the burden of calculating and keeping track of complex accelerated depreciation on those items. This type of relief could be expanded. For example, in his fiscal year 2017 budget, the president proposed increasing the maximum deduction to $1 million, while retaining the current-law phase-out.[100]

Policy makers could also look beyond tax policy to help small businesses. For example, approximately two-thirds of new U.S. entrepreneurs have some college education, and more education is highly correlated with the motivation to start a business.[101] Thus, ensuring that students with interest and ability are able to access the higher-education system is central to building America's pipeline of future entrepreneurs. Similarly, investments in science and technology have led to the founding of commercial applications that were ultimately very successful.[102]

Conclusion

The old rationales for business organization have eroded when it comes to business taxation at the federal level. It is possible to take tax out of the equation by leveling the playing field between business types while protecting the tax base. Businesses should be free to organize in the best way to succeed and be efficient at whatever their line of business. But businesses should contribute their fair share to all that government provides directly and indirectly to support a strong market. And, above all, large pass-through business organizations, especially large, complex partnerships, should not be used as tax havens for the wealthy.

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The Center for American Progress is an independent, nonpartisan policy institute that is dedicated to improving the lives of all Americans, through bold, progressive ideas, as well as strong leadership and concerted action. Our aim is not just to change the conversation, but to change the country.

Our Values

As progressives, we believe America should be a land of boundless opportunity, where people can climb the ladder of economic mobility. We believe we owe it to future generations to protect the planet and promote peace and shared global prosperity.

And we believe an effective government can earn the trust of the American people, champion the common good over narrow self-interest, and harness the strength of our diversity.

Our Approach

We develop new policy ideas, challenge the media to cover the issues that truly matter, and shape the national debate. With policy teams in major issue areas, American Progress can think creatively at the cross-section of traditional boundaries to develop ideas for policymakers that lead to real change. By employing an extensive communications and outreach effort that we adapt to a rapidly changing media landscape, we move our ideas aggressively in the national policy debate.

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