Center for American Progress

The 'Trump Loophole' Would Benefit Millionaires, Not Small Businesses

By Alexandra Thornton and Seth Hanlon August 24, 2017

Both the Trump administration and House Republicans have proposed to cut the tax rate on income of passthrough businesses—a proposal that they repeatedly refer to as a tax cut for small businesses.[1] But in reality, this tax cut would create a new loophole for some of America's wealthiest business owners, including President Donald Trump.

A so-called small-business tax cut would only benefit the wealthy

Their proposals would cut the top tax rates on income from passthrough businesses. Passthroughs are businesses that do not pay the corporate income tax.[2] They include S corporations; partnerships; limited liability companies, or LLCs; and sole proprietors. The income of these businesses is "passed through" to the owners and taxed at regular individual income tax rates, which range from 10 percent for people with a modest amount of taxable income to 39.6 percent for those with very high incomes.[3]

While Trump and House Republicans describe their proposal as a tax cut for small businesses, the biggest beneficiaries are anything but small businesses. Some of the most profitable and largest companies in the United States are organized as passthroughs, including hedge funds and other financial firms, lobbying firms, and law firms. In fact, many people would be surprised to learn that large companies such as Bechtel and the Trump Organization are also passthrough businesses.[4] The largest accounting firms, such as PricewaterhouseCoopers, Ernst & Young, and Deloitte, as well as the largest global law firms, are as well.

It is mainly the owners of these really big passthroughs, which make the majority of all passthrough business income,[5] that would benefit from the proposed cut in the top passthrough business income tax rate.

Many small businesses would get little or nothing from a cut in the passthrough tax rate

Cutting the top tax rate for passthrough businesses from 39.5 percent to 15 percent (as Trump has proposed) or 25 percent (as the House GOP has proposed) would only benefit the comparatively small number of large passthrough businesses that currently pay higher tax rates. But 86 percent of passthrough businesses fall in the 25 percent bracket or lower, which means they would not benefit at all from cutting the top tax rate to 25 percent.[6] In fact, two-thirds of passthrough businesses are in the 15 percent bracket or lower and thus would not benefit from either proposal.[7]

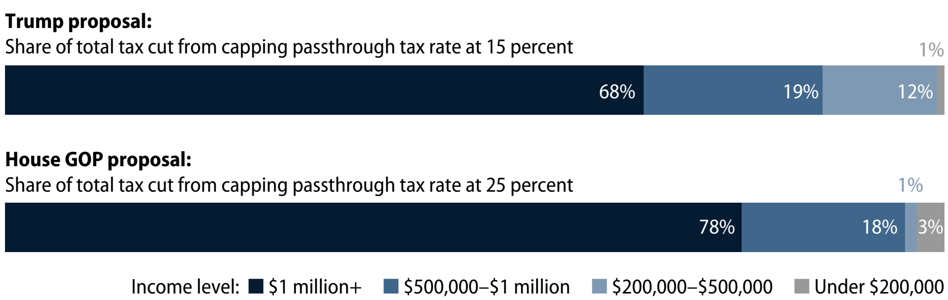
The Tax Policy Center has estimated the cost of this windfall for wealthy business owners and has shown just how skewed it is to the very top of the income ladder:

- Share of the tax cut that goes to millionaires: 68 percent under the Trump plan and 79 percent under the House GOP plan[8]
- Share of the tax cut that goes to taxpayers with annual incomes less than $200,000: 0.8 percent under the Trump plan and less than 2.9 percent under the House GOP plan
- Average tax cut for millionaires: $114,000 under the Trump plan and $49,000 under the House GOP plan

FIGURE 1

'Trump loophole' overwhelmingly benefits millionaires, not small businesses

Millionaires receive more than two-thirds of the tax benefit in the Trump plan and nearly four-fifths in House GOP plan



Sources: Modeling proposal in Tax Policy Center's Table T17-0163 is similar to Trump plan for 15 percent cap on tax rates for passthrough business income using broad definition. See Tax Policy Center, "T17-0163," available at http://www.taxpolicycenter.org/model-estimates/options-taxing-pass-through-income-prefential-rates-may-2017/t17-0163-distributional (last accessed August 2017). Modeling proposal in Tax Policy Center's Table T17-0165 is similar to House GOP plan for 25 percent cap on tax rate on passthrough business income using broad definition. See Tax Policy Center, "T17-0165," available at http://www.taxpolicycenter.org/model-estimates/options-taxing-pass-through-income-prefential-rates-may-2017/t17-0165-distributional (last accessed August 2017). Baseline for both estimates is current law with the alternative minimum tax repealed and an income tax rate structure with rates of 12 percent, 25 percent, and 33 percent, which is very similar to other proposals in the Trump and GOP tax plans.

Passthrough businesses already pay lower average tax rates than traditional corporations

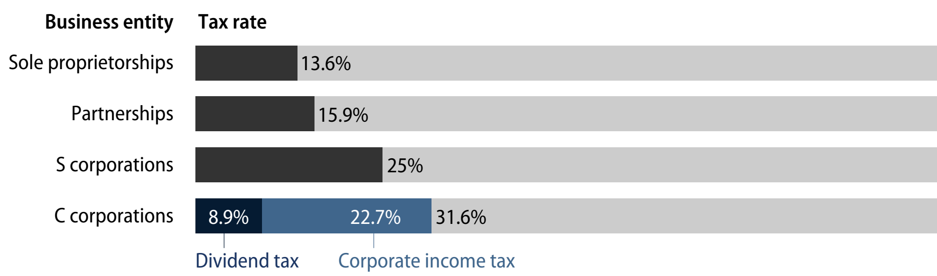
Some policymakers have argued that cutting the top passthrough rate is necessary to provide "parity" with C corporations. In fact, passthrough businesses today are taxed more favorably than C corporations.

Historically, S corporations and partnerships were created for smaller, simpler forms of business. But cuts to the individual tax rates in the Tax Reform Act of 1986 combined with more lenient legal rules for passthroughs across the 50 states led an increasing number of businesses to shift to LLC and S corporation form.[9] These companies can now enjoy limited liability for their owners, just as traditional, or C, corporations do, and have up to 100 unrelated shareholders or an unlimited number of partners, while not paying corporate income tax. Overall, the average effective tax rate for passthrough businesses—the percentage of their income that they actually pay in taxes, taking into account both business-level and owner-level taxes—is lower than for C corporations.[10]

FIGURE 2

Passthrough 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.

Lost revenue from the Trump loophole would threaten programs and investments that ensure economic opportunity for all Americans, including small-business owners

The Trump loophole would reduce federal revenue by $1.4 trillion over the next 10 years, according to the Tax Policy Center; when taking into account that business owners would recharacterize some of their wage and salary income to exploit the new loophole, the loophole would cost $2 trillion.[11] The House GOP passthrough tax cut would cost $572 billion over 10 years—or $664 billion, taking into account the recharacterization of income.

In their budgets, Trump and the House Republicans plan to pay for the Trump loophole and other tax cuts for the wealthy with cuts to programs that help ensure an economy that works for all, including small-business owners. For example, the Trump budget released in May would cut domestic programs (so-called nondefense discretionary programs) even further than they were cut under the automatic, across-the-board "sequestration" cuts.[12] These funds go to investments in education, job training, basic research, and infrastructure—which provide a foundation for economic growth and support domestic businesses.

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Endnotes

1 The White House one-pager can be viewed at Dylan Matthews, "Donald Trump's tax plan, in fewer than 500 words," Vox, April 26, 2017, available at https://www.vox.com/2017/4/26/15438404/trump-tax-plan-april-mnuchin-cohn-changes; Office of Speaker Paul Ryan, "A Better Way: Our Vision for a Confident America" (2016), available at https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

2 Joint Committee on Taxation, *Selected Issues Relating To Choice of Business Entity* (2012), available at https://www.jct.gov/publications.html?func=showdown&id=4478.

3 Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2017* (2017), available at https://www.jct.gov/publications.html?func=showdown&id=4989.

4 David Gelles, "Businesses Are Winning Cat-and-Mouse Tax Game," *The New York Times,* August 28, 2014, available at https://dealbook.nytimes.com/2014/08/28/businesses-find-ways-to-avoid-corporate-taxes-but-a-fix-seems-unlikely/?_r=0&mtrref=undefined&assetType=nyt_now&login=email; "Letter From Tax Firm on Russian Connections in Trump's Tax Returns," *The New York Times,* May 12, 2017, available at https://www.nytimes.com/interactive/2017/05/12/us/politics/document-Trump-Tax-Returns-Russia.html?mcubz=0.

5 Alexandra Thornton and Brendan Duke, "Ending the Pass-Through Loophole for Big Business" (Washington: Center for American Progress, 2016), available at https://www.americanprogress.org/issues/economy/reports/2016/08/10/139261/ending-the-pass-through-tax-loophole-for-big-business/.

6 Tax Policy Center, "Table T17-0075: Distribution of Business Income, by Statutory Marginal Tax Rate" (2017), available at http://www.taxpolicycenter.org/model-estimates/distribution-business-income-march-2017/distribution-business-income-statutory.

7 *Ibid.*

8 Tax Policy Center, "Table T17-0163: Distributional Effect of a 15-Percent Top Rate on a Broad Definition of Pass-Through Income" (2017), available at http://www.taxpolicycenter.org/model-estimates/options-taxing-pass-through-income-prefential-rates-may-2017/t17-0163-distributional; Tax Policy Center, "Table T17-0165: Distributional Effect of a 25-Percent Top Rate on a Broad Definition of Pass-Through Income" (2017), available at http://www.taxpolicycenter.org/model-estimates/options-taxing-pass-through-income-prefential-rates-may-2017/t17-0165-distributional.

9 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.

10 Michael Cooper and others, "Business in the United States: Who Owns It and How Much Tax They Pay" (Cambridge, MA: National Board of Economic Research, 2015), earlier versions available at http://www.ericzwick.com/pships/pships.pdf and https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-104.pdf. See also Alexandra Thornton and Brendan Duke, "Ending the Pass-Through Loophole for Big Business" (Washington: Center for American Progress, 2016), available at https://www.americanprogress.org/issues/economy/reports/2016/08/10/139261/ending-the-pass-through-tax-loophole-for-big-business/. The effective corporate income tax rate takes into account the corporate income tax and the low tax rate on dividends that are distributed to owners or shareholders.

11 Tax Policy Center, "Table T17-0162: Revenue Effect of Options for Taxing Pass-Through Income at Preferential Rates, Baseline" (2017), available at http://www.taxpolicycenter.org/model-estimates/options-taxing-pass-through-income-prefential-rates-may-2017/t17-0162-revenue-effect.

12 David Reich, "Trump Budget would Cut Non-Defense Programs to half Their 2010 Level," Center on Budget and Policy Priorities, May 23, 2017, available at https://www.cbpp.org/blog/trump-budget-would-cut-non-defense-programs-to-half-their-2010-level.