June 27, 2017

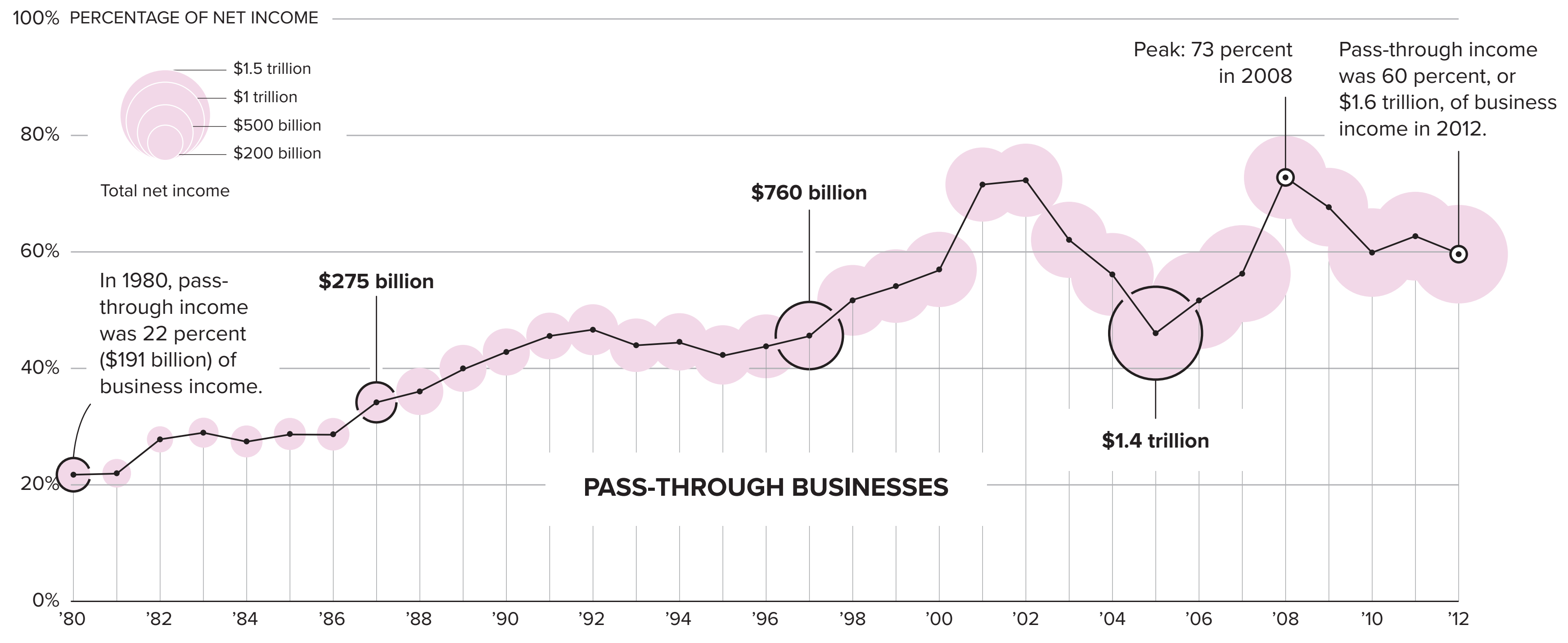
The Rise Of The Pass-Through Entity

Tax reform has included discussion of lowering the top corporate income tax rate to as low as 15 percent. However, the majority of U.S. businesses are not taxed on corporate rates. Instead, most businesses file returns as pass-through businesses, which are taxed on individual rates. From 1980 to 2012, pass-throughs' share of total corporate tax returns never fell below 83 percent of all business returns. Over the same time period, pass-through entities' share of net income rose 38 points, to 60 percent of net business income in 2012.

Pass-Through Entities Responsible for a Majority of U.S. Business Income

In 2012, 31.1 milion returns were filed for pass-through businesses, which include S corporations, partnerships, and nonfarm sole proprietorships. That year, these businesses reported net income (less deficit) of $1.6 trillion, about 60 percent of all net business income.

Pass-throughs' share of net business income and total pass-through income* (adjusted to 2016 real dollars)

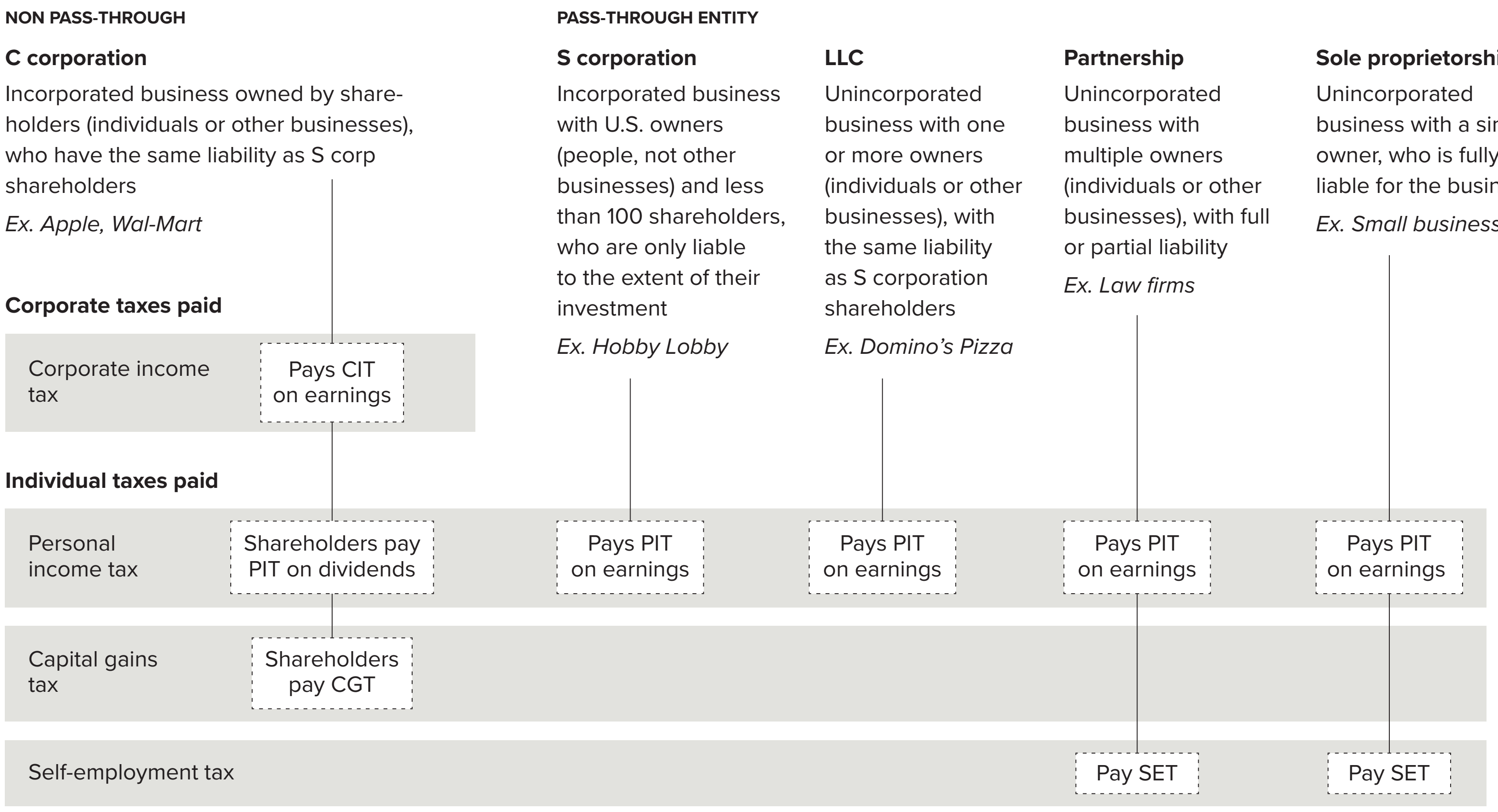


*Business income is net income less deficits for C corporations, S corporations, partnerships and nonfarm sole proprietorships, does not include RICs or REITs; pass-throughs are S corporations, partnerships and nonfarm sole proprietorships

Pass-Through Entities Are Not Doubled-Taxed But Pay High Marginal Rate

C corporations — businesses that are not pass-throughs — are subject to double taxation. They pay corporate income tax on earnings, and C corporation owners and shareholders also pay income tax on dividends or capital gains from the company. On the other hand, income from pass-through entities is only taxed once: when entities pass income and losses to their owners, who pay personal income tax on earnings.

While pass-throughs benefit from single taxation, C corporations benefit from deferral. C corporations can defer domestic taxation of foreign income, and C corporation owners and shareholders can defer taxation on dividends and capital gains. Pass-through owners cannot defer taxation on income. **Types of businesses — C-corporations and pass-throughs — and the taxes they pay:**

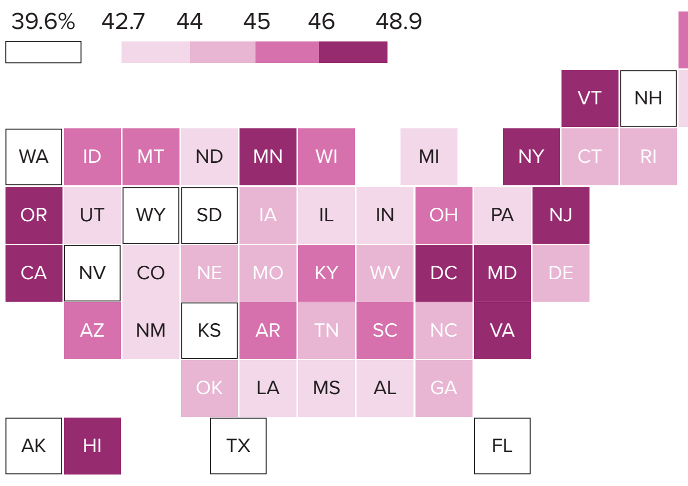


Top marginal tax rates of pass-through entities

Differences in tax rates exist even within pass-through organizations. For example, S corporations face an average 44.5 percent marginal tax rate across the nation, while partnerships and sole proprietorships face an average marginal tax rate of 47.3 percent. C corporations face an average marginal tax rate of 39.1 percent, but C corporation shareholders face additional personal taxes on related income.

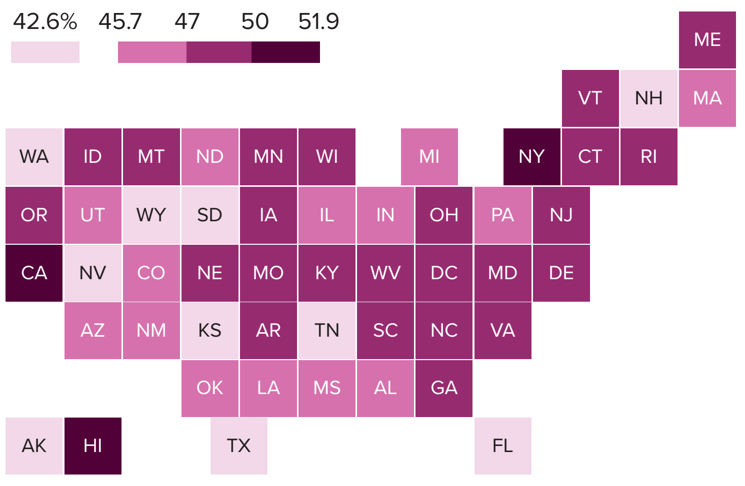
Active shareholders of S corporations

MARGINAL TAX RATE



Sole proprietorships and partnerships

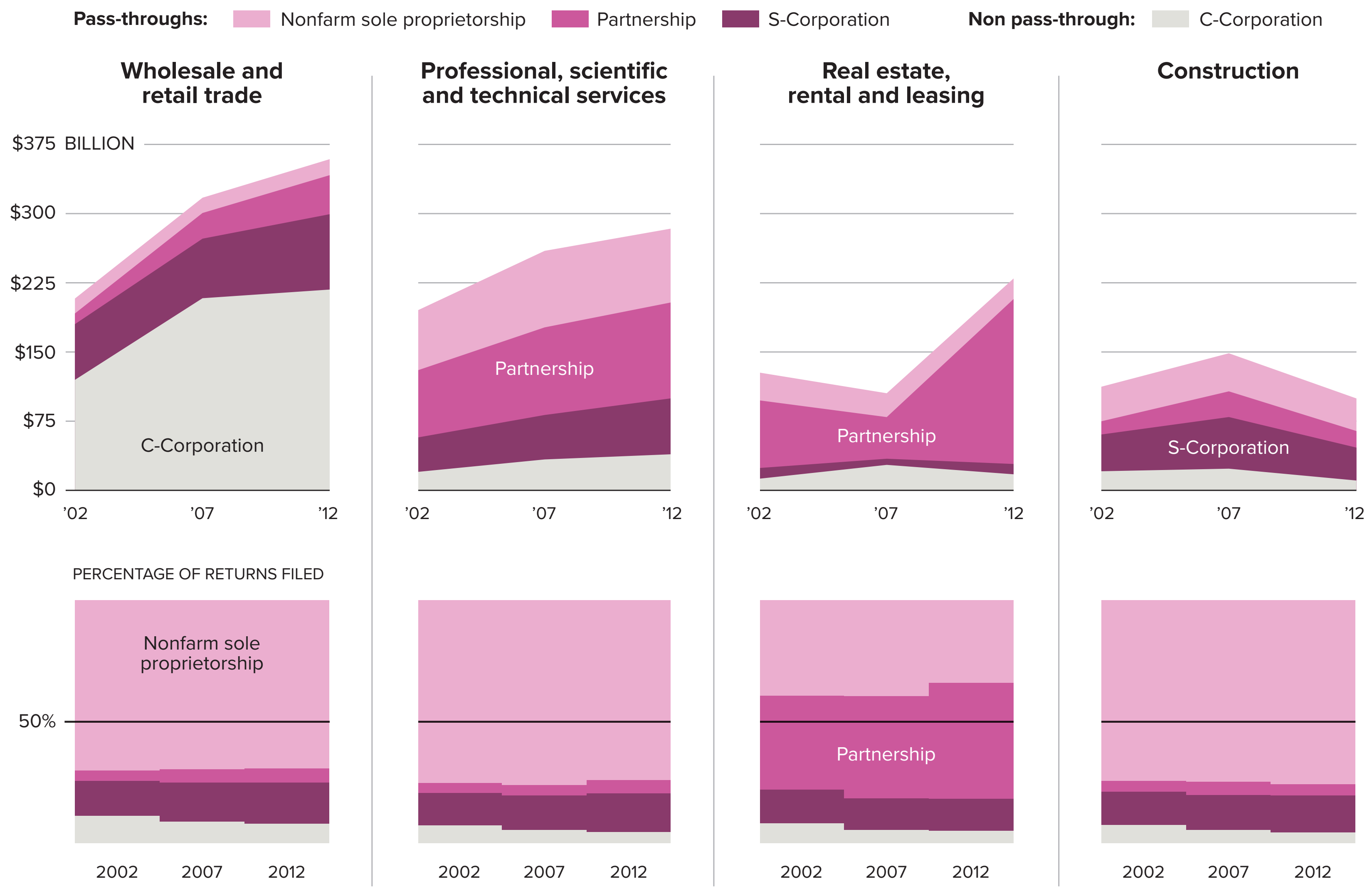
MARGINAL TAX RATE



Pass-Through Income Gains Also Seen On Industry Level

The overall increase in pass-through income is also visible at the industry level. The top four industries, by number of returns filed — wholesale and retail trade; professional, scientific and technical services; real estate and rental and leasing; and construction — have had an increasing share of pass-through returns filed. Net income within these industries also increased, with the exception of construction, which was lower in 2012 than in 2007.

Net income of pass-throughs and C-Corporations, top four industries by returns filed*



*Income included is: C-Corporation, net income; S-Corporation, net income (less deficit) from a trade or business; Partnership, total net income (loss); Non-Farm Sole Proprietorships, net income less deficit

By Taylor Thomas, POLITICO Pro DataPoint

Sources: IRS; the Tax Foundation