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ECONOMIC ANALYSIS

Passthroughs Shrink the Corporate Tax by $140 Billion

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The corporate tax is a horse-and-buggy revenue apparatus. It gets the job done, but the maintenance and mess no longer make sense.

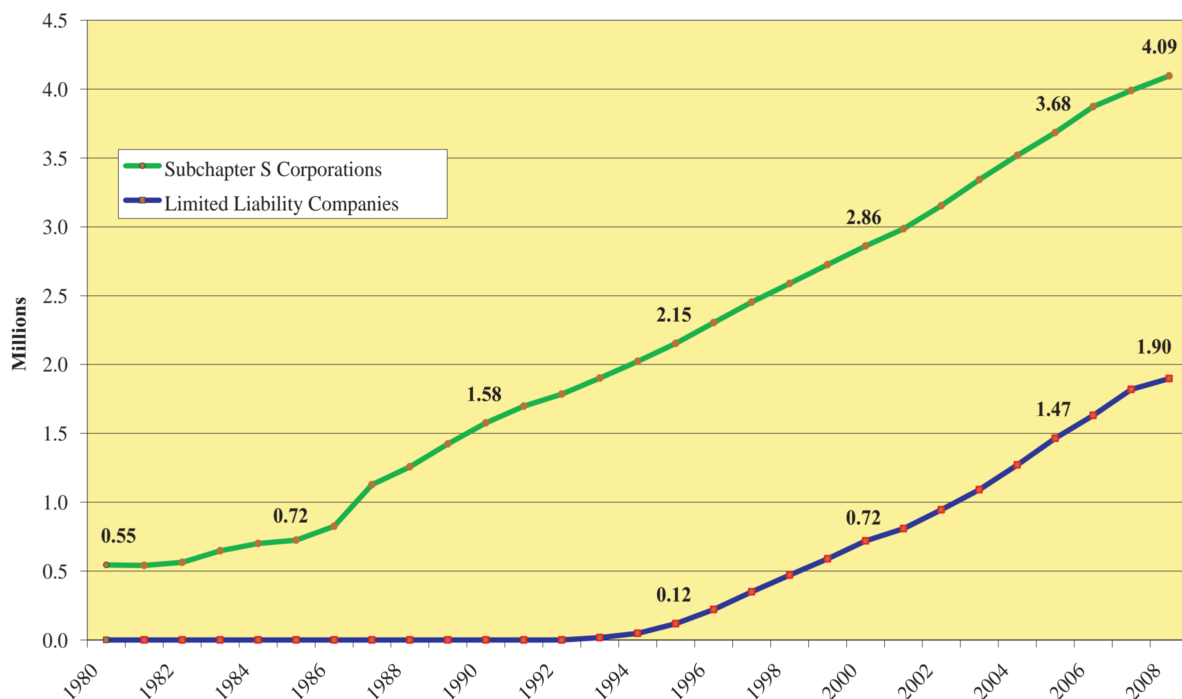
Nowhere is the inefficiency of the tax more apparent than in the porous border between one group of businesses that must pay the tax and the other that can escape it. Subchapter C corporations pay the tax at a 35 percent rate on profits, and owners pay tax on any distributions. Most, but not all, C corporation profits are from America's largest companies.

Businesses that do not pay corporate tax are collectively known as passthrough entities. The profits of these businesses — whether distributed or not — immediately show up on owners' individual tax returns. The three major forms of passthrough entities are subchapter S corporations, partnerships, and sole proprietorships. Most, but not all, profits from passthroughs come from small and medium-size businesses.

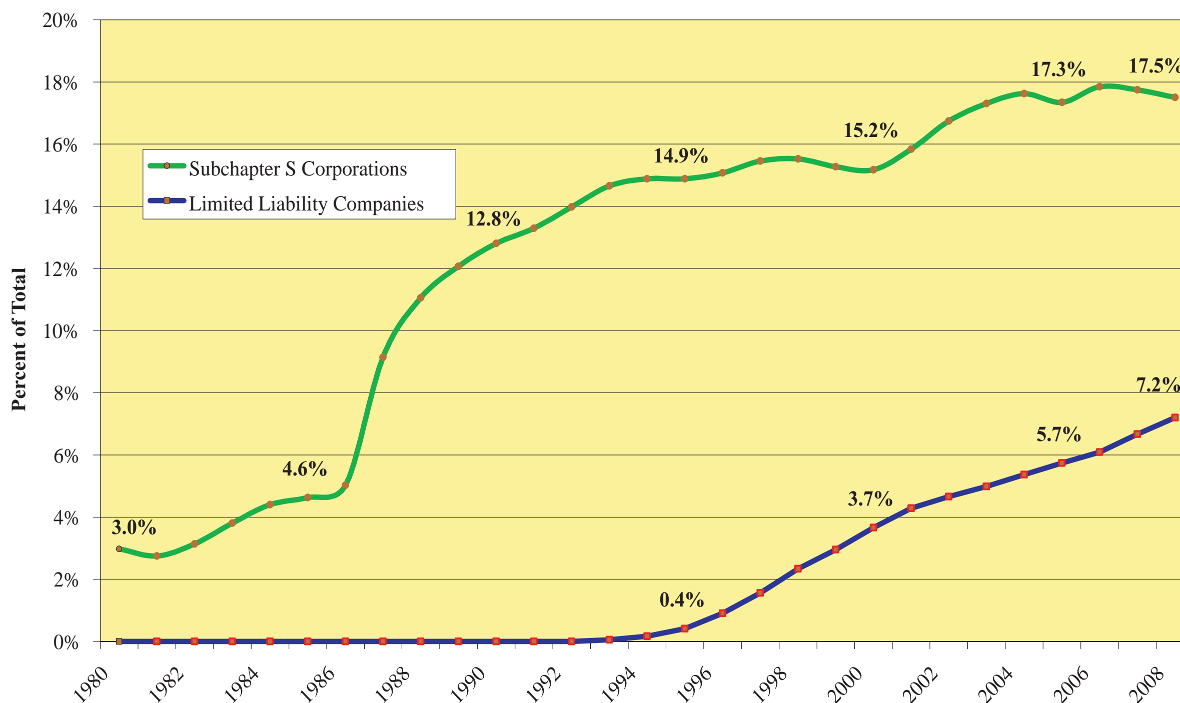
Why do some business earnings face two levels of tax? Don't look to economics for the answer. Most economists condemn the corporate tax as a drag on growth and an incentive for corporate leverage. Only the politics make sense. Taxing business is easier than taxing households directly. But taxing small business isn't popular either. So we are left with a ragtag system that concentrates the double tax on large businesses.

Even if you accept the preferential treatment of small business as acceptable on political grounds, the policy in practice is a mess. The rules on what distinguishes double-taxed and passthrough entities are complex and arcane. And they change in fits and starts.

Figure 1. Number of Subchapter S Corporations and LLCs, 1980-2008



Source: IRS, Statistics of Income division, Integrated Business Data, Table 1, *available at* http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html.



Source: IRS, Statistics of Income division, Integrated Business Data, Table 1, *available at* http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html.

Over the past three decades, the number and the importance of passthrough entities have grown enormously, because of the growth of S corporations and limited liability companies that file as partnerships. Although Congress added subchapter S to the code in 1958, it was not until the Tax Reform Act of 1986 lowered the top individual rate below the corporate rate that S corporations gained mass appeal. The growth of LLCs was made possible by a 1988 IRS revenue ruling that treated Wyoming's LLCs as partnerships for tax purposes and by the subsequent adoption of LLC rules in all U.S. states. You can see this in figures 1 and 2.

Some of the growth in S corporations and LLCs has resulted in a decline in other passthrough entities, namely sole proprietorships and non-LLC partnerships. Many businesses that in the past might have been sole proprietorships are now S corporations with one shareholder. And businesses that might have been traditional partnerships can now have the tax advantages of a partnership and the legal advantages of a corporation by adopting LLC status.

But the rise of S corporations and LLCs has also taken a big bite out of the taxable corporate sector. Figure 3 shows the share of various indicators of business activity between 1980 and 2007. The taxable corporate sector's share has declined significantly.

Once the economy recovers from the recession, the government is expecting to collect about $400 billion per year from the corporate tax (Congressional Budget Office, ''The Budget and Economic Outlook: Fiscal Years 2011 to 2021,'' Jan. 2011, Table 4.6, *Doc 2011-1753*, *2011 TNT 18-16*). Using Figure 3 as our guide, we can estimate the impact on corporate revenues of the rising use of passthrough entities.

> ***If not for the rapid growth of passthrough entities, projected corporate tax revenues for 2015 would be nearly 3 percent of GDP instead of 2.2 percent.***

If the corporate sector's share of business stayed at the same level as it was in 1999, it would be about 10 percent larger. Assuming tax liability is proportionate to gross receipts, this would increase corporate revenue by $40 billion. If the corporate sector's share of business stayed at the same level as it was in 1990, it would be about 35 percent larger — an increase in corporate revenue of $140 billion. So, for

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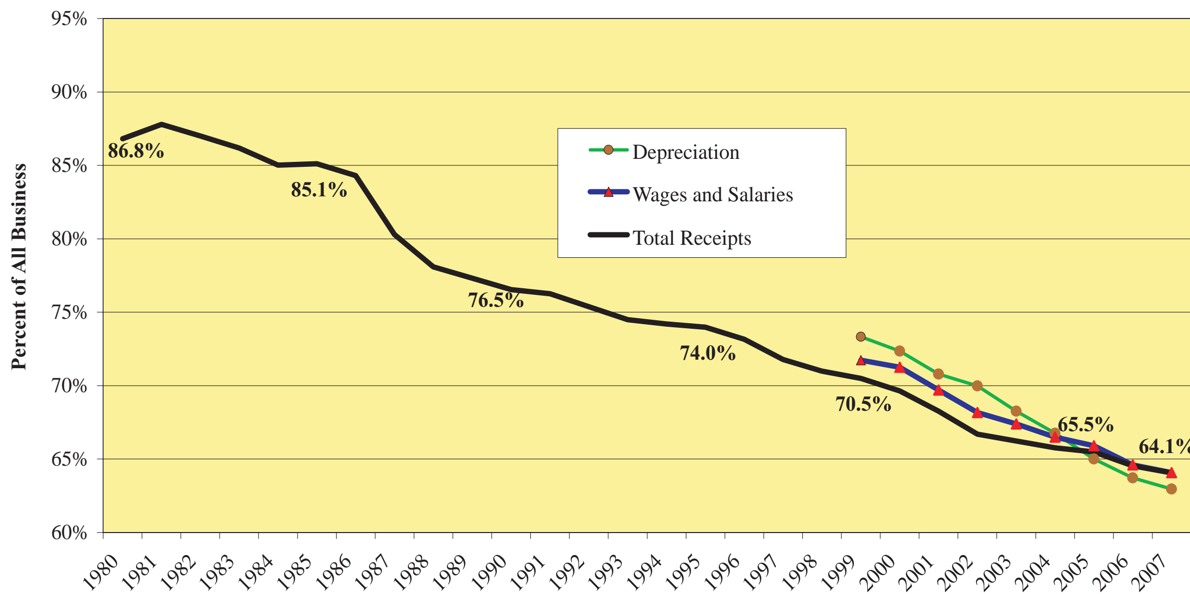
Figure 3. Subchapter C Corporations' Declining Share of Business Activity, 1980-2007



Source: IRS, Statistics of Income division. Receipts data are from Integrated Business Data, Table 1, *available at* http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html. Other data are available on a consistent basis only beginning in 1999. Depreciation and salary data for partnerships are from "SOI Bulletin Historical Table," *available at* http://www.irs.gov/taxstats/bustaxstats/article/0,,id=97119,00.html. C corporation data are from Table 12, "Returns of Active Corporations, Other Than Forms 1120S, 1120-REIT, and 1120-RIC," *available at* http://www.irs.gov/taxstats/bustaxstats/article/0,,id=112834,00.html. S corporation data are from Table 7, "Returns of Active Corporations, Form 1120S," *available at* http://www.irs.gov/taxstats/bustaxstats/article/0,,id=112834,00.html. Non-farm sole proprietorship data are from a table entitled "Business Receipts, Selected Deductions, Payroll, and Net Income," *available at* http://www.irs.gov/taxstats/indtaxstats/article/0,,id=134481,00.html.

example, instead of being a projected 2.2 percent of GDP in 2015, corporate tax revenue would be nearly 3 percent of GDP.

Castle Built on Sand

What should we make of this fundamental shift in business taxation? First, we should be careful not to interpret the $140 billion figure as a pure revenue loss. Much of the corporate tax's loss is the individual income tax's gain. Back-of-the-envelope calculations suggest that the net revenue loss to the government is probably more like one-third of the gross figure.

Second, we should recognize that the movement from double taxation to flow-through taxation is a step in the direction of sound policy. Tax reformers and professors will tell anyone who will listen that all business income should be taxed on a flow-through basis. They call it integration.

The major problem with our widespread self-help integration is that those businesses that do not qualify and those who do not want to incur the expense of reorganization are left worse off because they are at a competitive disadvantage. It would be much better if business tax relief were spread evenly among all businesses and not just those that are passthrough entities. Alternatively, if there must be differential treatment, there should be a policy rationale for the distinction and a bright-line test that is more administrable.

The disparate treatment of C corporations and passthrough entities makes clear that any corporate tax reform that does not address that issue is not much of a reform. Our best thinkers on the subject understand this. For example, in 1992 and 2007 the Treasury Department called for replacing the corporation tax with a broad-based uniform tax on all business. More recently, Alan Auerbach of the University of California at Berkeley made a similarly themed proposal ("A Modern Corporate Tax," the Hamilton Project and the Center for American Progress, Dec. 2010, *Doc 2010-25625*, *2010 TNT 233-104*). Unfortunately, our leaders are not ready to consider this type of rational reform.

In the meantime, corporate tax reformers are left in the awkward position of trying to improve a fundamentally unsound tax. If we broaden the corporate tax base by trimming tax incentives (for example, accelerated depreciation), should those same tax incentives be trimmed for passthrough entities? Many would like to keep tax reform confined to the corporate sector. But politics aside, isn't it reasonable to suggest that passthrough businesses that are relatively lightly taxed pay more to reduce taxes on C corporations? ■

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