What are flow-through enterprises and how are they taxed?

Most US businesses are not subject to the corporate income tax. Rather, profits flow through to owners and are taxed under the individual income tax. Flow-through businesses include sole proprietorships, partnerships, and S corporations.

Many businesses are taxed as flow-through entities that, unlike C corporations, are not subject to the corporate income tax. Instead their owners include their allocated shares of profits in taxable income under the individual income tax, which is taxed as ordinary income up to the maximum 39.6 percent rate. Flow-through businesses include sole proprietorships, partnerships, and S corporations.

ADVANTAGES OF FLOW-THROUGH ENTITIES

Flow-through businesses generally face the same tax rules as C corporations for inventory accounting, depreciation, and other provisions affecting the measurement of business profits. But organizing as a flow-through business has several advantages. The first is that income is only subject to a single layer of income tax, unlike C corporation profits, which are first subject to the corporate income tax (at rates up to 35 percent) and then taxed again when paid out as dividends to shareholders or when shareholders realize capital gains arising from retained earnings (at rates up to 23.8 percent). In contrast, profits from flow-through businesses are taxed just once, at the owner's individual tax rate for ordinary income.

Another benefit of flow-through status is that individuals may deduct business losses against current income from other sources, subject to some limitations for "passive losses." In contrast, C-corporation losses cannot be used to offset income earned outside the corporation. C-corporation losses may, however, be carried back (up to two years) or carried forward (up to 20 years) and deducted against profits in previous or future years. To the extent corporations are unable to claim loss carrybacks, the tax benefit from these losses is delayed and reduced in terms of present value.

TYPES OF FLOW-THROUGH ENTITIES

Sole Proprietorships: A business with a single owner does not file a separate tax return, but rather reports its net income on Schedule C of the owner's individual tax return. Generally all net income from sole proprietorships is also subject to payroll taxes under the Self Employed Contributions Act (SECA).

Partnerships: Partnerships file an entity-level tax return (Form 1065), but profits are allocated to owners who report their share of net income on Schedule E of their individual tax returns. Under "check the box" regulations instituted by the Treasury Department in 1997, limited-liability companies (LLCs) can elect to be taxed as partnerships. General partners are subject to SECA tax on all their net income, while limited partners are only subject to SECA tax on "guaranteed payments" that represent compensation for labor services.

S Corporations: Eligible domestic corporations that elect S-corporation status file a corporate tax return (Form 1120S), but profits flow through to shareholders and are reported on Schedule E of the shareholders personal income tax. S corporations cannot have more than 100 shareholders, and those shareholders must be US citizens or resident individuals (although certain estates, trusts, and tax-exempt organizations are also allowed). In addition, S corporations may have only one class of stock. S corporation owners do not pay SECA tax on their profits, but are required to pay themselves "reasonable compensation," which is subject to the regular Social Security tax (i.e., the Federal Insurance Contributions Act or FICA).

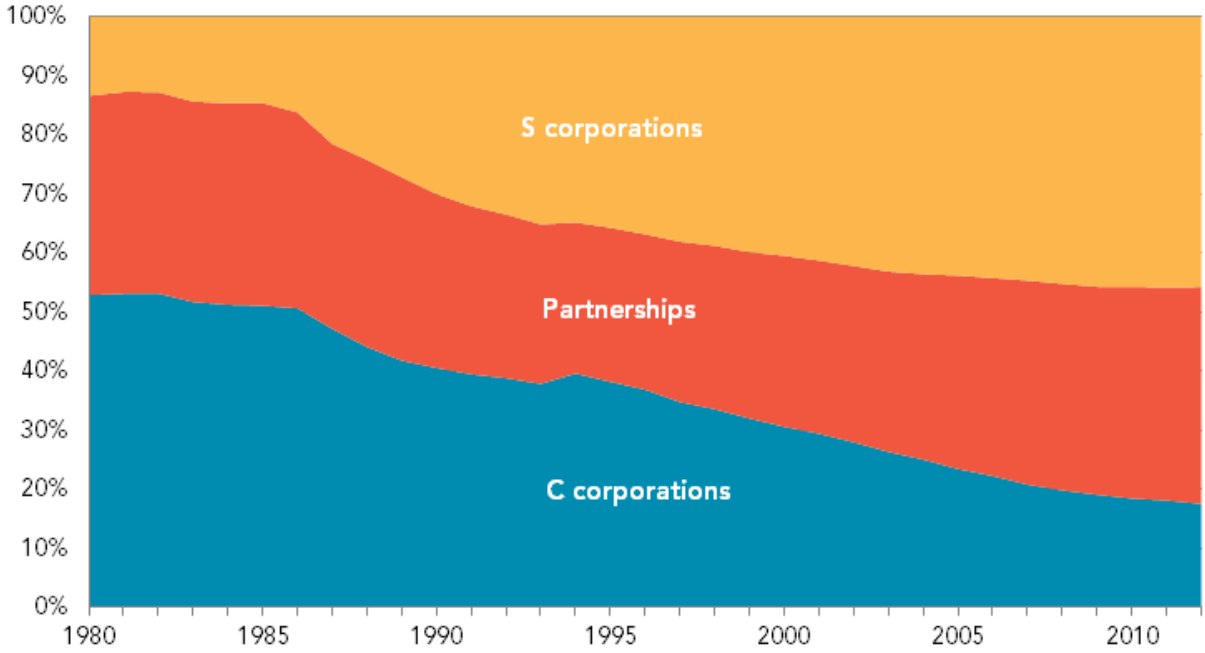
GROWTH IN FLOW-THROUGH BUSINESSES

The share of business activity represented by flow-through entities has been rising since the passage of the Tax Reform Act of 1986. Excluding sole proprietorships (which receive just 4 percent of total business revenue), more than 80 percent of businesses were organized as flow-through entities in 2012—up from 49 percent in 1985 (figure 1). During that same period the share of business receipts going to flow-through entities increased from 9 percent to 36 percent (figure 2).

Recent research using IRS tax data found that fully half of all business profits are earned by pass-through entities, and that the average federal income tax rate paid is 19 percent (Cooper et al. 2015).

FIGURE 1

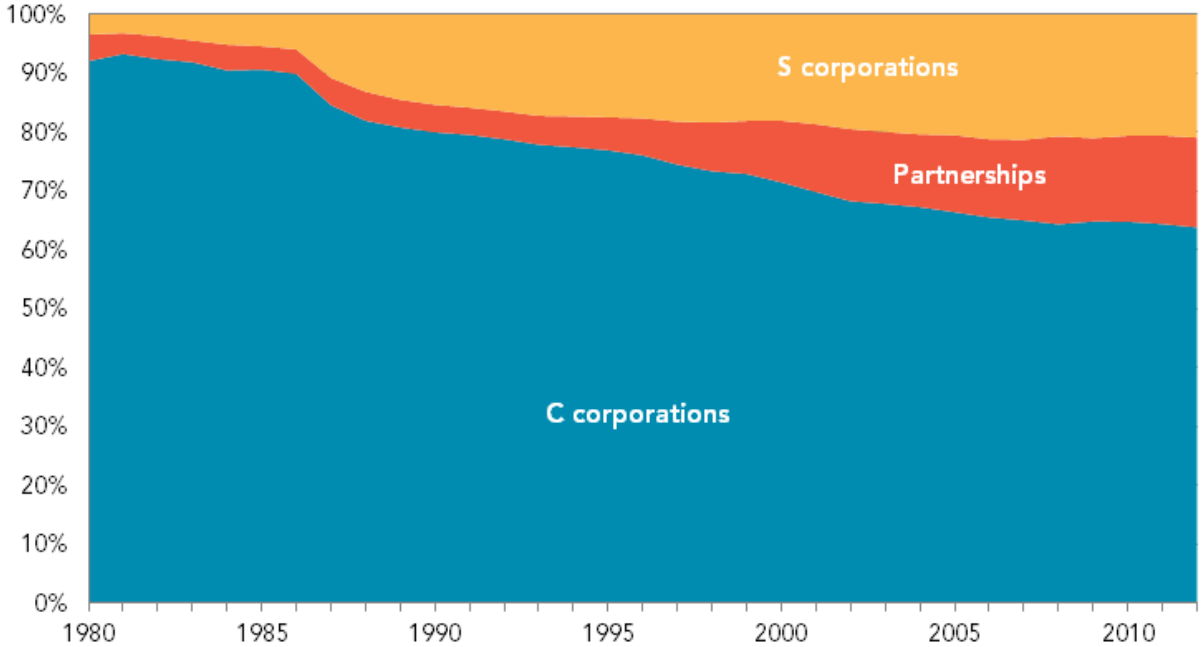
Share of Business Returns by Type
1980–2012



Source: Internal Revenue Service, Statistics of Income Division, Integrated Business Data, Table 1.

FIGURE 2

Share of Business Receipts by Type
1980–2012



Source: Internal Revenue Service, Statistics of Income Division, Integrated Business Data, Table 1.

DATA SOURCE

Internal Revenue Service, Statistics of Income Division. Table 1. "Selected Financial Data on Businesses."

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