Options to Reduce the Taxation of Pass-through Income

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OVERVIEW

The Trump administration and House Republicans are developing proposals that would reduce the individual income tax rate on income earned through pass-through entities such as sole proprietorships, partnerships, and S-corporations.

To analyze the impact of reducing the individual income tax rate on pass-through income, we use TPC's microsimulation model of the federal tax system to estimate the revenue and distributional effects of several illustrative options relative to a baseline that repeals the individual alternative minimum tax (AMT) and implements ordinary income tax rates of 12, 25, and 33 percent. We provide estimates for two different definitions of qualifying pass-through income—a broad base and a narrow base—and for two different top pass-through tax rates, 15 and 25 percent.

Applying a 15-percent rate to a broad definition of pass-through income would reduce federal tax revenue by $1.36 trillion over the next ten years before accounting for any potential re-characterization of wages as qualifying pass-through income. Including such "income shifting" could increase the revenue loss to $1.95 trillion. A 25-percent rate on a narrow definition of pass-through income would result in a ten-year revenue loss of about $390 billion without shifting, and $410 billion once we take income shifting into account.

The benefits of reducing the tax rate on pass-through income would flow to a relatively small number of almost exclusively high-income households. More than three-quarters of the net benefit of a 15-percent rate on a broad definition of pass-through income would go to those in the top one percent of the income distribution, who would see an average increase in their after-tax income of 4.8 percent, or about $76,000. The proposal would cut taxes for fewer than 5 percent of households in the middle quintile of the income distribution; those households would see an average tax cut of $370. In contrast, more than three-fifths of the households in the top one-tenth of one percent of the income distribution—those with incomes exceeding $3.4 million—would benefit; those households would receive an average tax cut of almost $638,000.

A top rate of 25 percent rate would result in a smaller net tax reduction overall, would affect a smaller number of households, and would be tilted even more heavily toward those at the top of the income distribution. These results all follow from the narrower disparity in tax rates (33 percent on ordinary income vs. 25 percent on pass-through income).

DETAILS OF SIMULATIONS

The proposals to lower the tax rate on pass-through income are part of broader plans that would also eliminate the individual AMT and lower statutory individual income tax rates. We therefore estimate the impact of our illustrative proposals against a baseline that would repeal the AMT and reduce income tax rates. In our baseline, we assume that the current system of seven individual income tax rates ranging from 10 to 39.6 percent would be replaced with three rates of 12, 25, and 33 percent. These are the rates that House Republicans proposed in their Better Way tax reform plan. We assume that the 25 and 33 percent rates would begin at income levels equal to the thresholds for the current-law 25 and 33 percent rates.

We assume that the special tax rates on qualifying pass-through income would be applied in a similar way to the preferential rate structure for capital gains and qualified dividends under current law. Thus, we treat the rates on qualifying pass-through income as rate caps. Finally, we assume that there would be no second layer of dividend tax on distributions to the owners of pass-through entities.

Defining qualifying pass-through income

The broad definition of qualifying pass-through income includes all net income earned by sole proprietorships and farms (reported on Schedules C and F), as well as all net partnership and rental income and all S-corporation profits (reported on Schedule E). Qualifying pass-through income excludes investment income, such as capital gains, dividends, and interest received from hedge funds.

The narrow definition of qualifying pass-through income includes all nonpassive S-corporation profits; 30 percent of net income from sole proprietorships, farms, and rents; and 30 percent of net nonpassive income from partnerships. The 30 percent figure is based on a related provision in the tax reform proposal advanced by former House Ways and Means Chairman Dave Camp and is intended to restrict, in a mechanical way, the benefit of the lower tax rate to non-labor income.

Treatment of pass-through losses

Under current law, net losses from pass-through entities can generally offset ordinary income from wages and other sources. To retain symmetry between the treatment of net income and net losses under these proposals, we do not allow net losses from pass-through sources to offset income taxed at ordinary rates. Instead, we allow losses to reduce individual income tax liability, but not below zero, at a rate equal to the top pass-through tax rate. This is roughly equivalent to providing a non-refundable tax credit of 15 (or 25) percent for net losses from pass-throughs.

Re-characterizing ordinary income as pass-through income

Under these proposals, the differential between the tax rates on pass-through income and ordinary wages would create an incentive for many earners to re-characterize their wage income to qualify for the preferential tax rates. To reflect this possibility, we provide revenue estimates with and without such income shifting. We base our estimate of the amount of shifting on the potential total tax savings that each taxpayer would realize by re-characterizing all wage income as pass-through income. We estimate that the total income shifting would equal between 1.0 and 8.3 percent of wages, depending on the proposed income definitions and tax rate. Because income shifting would occur over time as techniques to shift income are deployed throughout the economy, we phase in its revenue effects proportionately over five years. Our distributional analysis does not include any effects of income shifting.

Impact on payroll taxes

We assume that the proposals would not change the definition of the payroll tax base: Pass-through income that is currently subject to payroll tax would continue to be subject to it.

In addition, we assume that any wages that taxpayers re-characterize as pass-through income would remain subject to payroll taxes. We do this for several reasons. First, the proposals would not change the definition of income subject to payroll tax. Thus, earnings shifted to sole proprietorship or general partnership income would be subject to self-employment tax at the same rate as the combined employer-employee payroll taxes is imposed on wages, even though the shifted earnings would become fully or partially eligible for the lower pass-through income tax rates.

The considerations for choosing the S corporate form to shift wages are more complicated. Although S corporation profits are not subject to payroll taxes, owners are required to pay themselves "reasonable compensation" that is taxed as wages. Ultimately, the incentive to elect S corporate form would depend on several factors. They include the rate differential between wages and qualifying pass-through income, how broadly the preferential rate applies, and the amount of reasonable compensation relative to overall net income. We assume that individuals would prefer to shift their wages to sole proprietorship or partnership income, where all income would be eligible for the lower pass-through rate, instead of S corporate form, where only the profits portion would benefit.

Our estimates do not consider other behavioral responses that may reduce payroll taxes. One response might be to re-characterize wages as a form of passive income such as a non-guaranteed payment to a limited partner. Alternatively, current owners of closely-held S corporations could substitute profits for wages to benefit from both the payroll tax exemption and the lower income tax rate. Both responses could be characterized as evasion rather than avoidance. Both would increase revenue losses and reduce transfers to the Social Security and Medicare trust funds.

SIMULATION RESULTS

Revenue

A 15 percent top rate on a broad definition of qualifying pass-through income would reduce federal tax revenue by about $1.36 trillion over the next ten years before accounting for any potential income shifting (Table T17-0162). Including the effects from the re-characterization of wage income increases the estimated cost by more than $580 billion to $1.95 trillion over ten years.

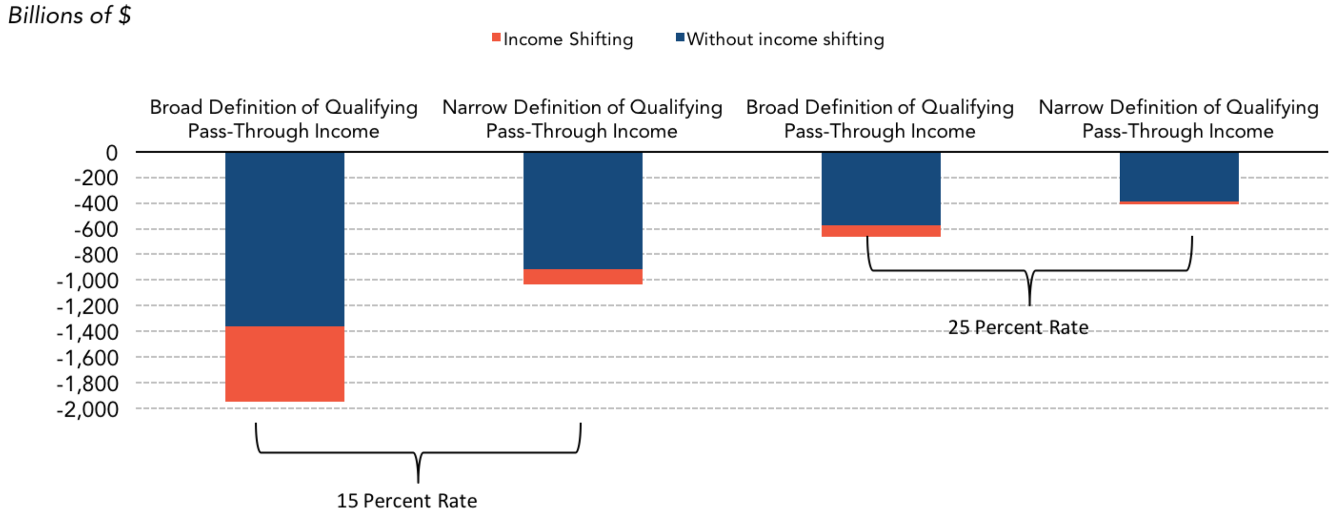
Applying the same 15 percent rate to a narrow definition of qualifying pass-through income reduces the ten-year cost without shifting to $910 billion. Because the narrower base reduces the incentive to shift, the impact of wage recharacterization is proportionately less in this case.

FIGURE 1

Revenue Effect of Options to Lower the Maximum Tax Rate on Pass-through Income

2018-2027

Billions of $



Source: Urban-Brookings Microsimulation Model (version 0217-1).

Nonetheless, we estimate that wage shifting would add $120 billion to the ten-year cost, resulting in a total revenue loss of $1.04 trillion.

Imposing a 25 percent top tax rate would reduce the revenue losses substantially because the rate differential is smaller. Applying that rate to a broad definition of pass-through income would cost about $570 billion over the next ten years without including the impact of income shifting. The rate differential between pass-through income and ordinary income would be smaller with a 25 percent rate than a 15 percent rate and thus would create less incentive for income shifting. Nonetheless, we estimate that the re-characterization of income could reduce revenue by an additional $90 billion over ten years, raising the total cost to $660 billion.

Finally, applying a 25-percent top rate to a narrow definition of pass-through income would reduce federal tax revenue by $390 billion over the next ten years. Income shifting could increase the cost to about $410 billion.

Distribution

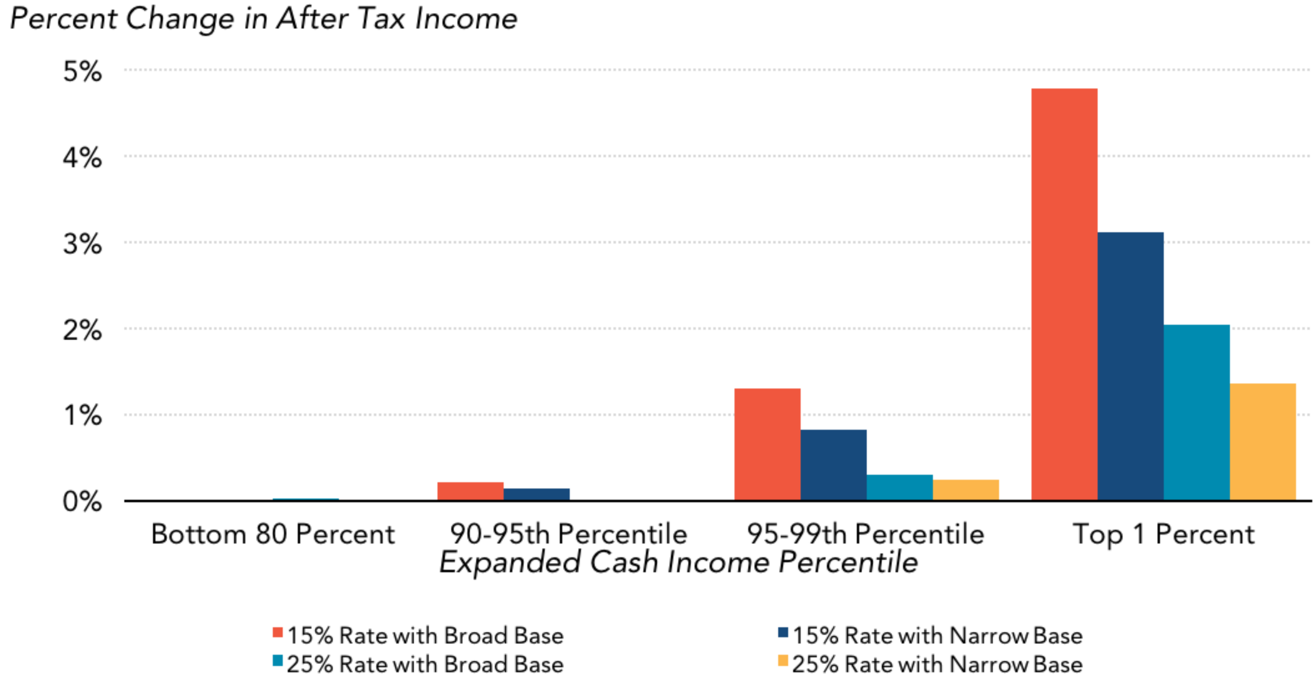
TPC estimates that in 2017, more than two-thirds of households with pass-through income will be in the 15-percent tax bracket or below; an additional 19 percent will be in the 25 percent bracket. By contrast, TPC estimates that in 2017, households in the top 20 percent of the income distribution will earn approximately 86 percent of net pass-through income while the top 1 percent will earn more than half. It is not surprising, therefore, that lowering the tax rate on pass-through income would affect few taxpayers in the middle or bottom of the income distribution but provide large tax reductions to a relatively small number of households at the top of the income distribution.

If a 15-percent top rate is applied to a broad definition of pass-through income, virtually all the net tax reduction would go to households in the top 20 percent of the income distribution (Figure 2 and Table T17-0164). More than three-quarters of the net benefit would go to those in the top one percent of the income distribution, who would see an average increase in their after-tax income of 4.8 percent, or about $76,000. Overall, the proposal would cut taxes for just 6.6 percent of households, by an average amount of about $11,300. Because we assume that net losses from pass-through entities would no longer be allowed to offset ordinary income, we estimate that about 4.5 percent of all households would face a tax increase, averaging about $2,300.

FIGURE 2

Distributional Effect of Options to Lower the Maximum Tax Rate on Pass-Through Income

By Expanded Cash Income Percentile, 2018



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0217-1).

The proposal would cut taxes for fewer than 5 percent of households in the middle of the income distribution, by an average amount of $370. In contrast, more than three-fifths of the households in the top one-tenth of one percent—those with incomes exceeding $3.4 million—would benefit. On average, they would see their taxes cut by almost $638,000.

Applying the 15 percent rate to the narrow definition of qualifying pass-through income would reduce the overall magnitude of the tax change and the number of households that would benefit. However, it would result in very little change to the distribution (Table T17-0168). More than three-quarters of the net tax reduction would still flow to households in the top one percent of the income distribution. They would receive an average increase in after-tax income of 3.1 percent or $49,500. Only 4.5 percent of households in the middle of the income distribution would benefit from the proposal. They would receive an average tax cut of $240. In contrast, 55 percent of households in the top one-tenth of one percent of the income distribution would benefit by an average of $495,000.

Under a 25-percent top rate, only pass-through income that would otherwise be taxed at the top rate of 33 percent would generally benefit from the lower rate. Thus, a 25-percent rate cap would reduce the size of the overall tax cut and the number of households that would benefit, but it would tilt the set of households benefitting from the net tax reduction even more toward the top of the income distribution. If a 25-percent rate is applied to a broad definition of pass-through income, 88 percent of the net tax benefit would go to the top one percent of the income distribution. Those households would see an average increase in their after-tax income of 2.0 percent or $32,500 (Table T17-0166). Overall, this proposal would cut taxes for 3.8 percent of households, by an average amount of about $7,300. Approximately 2.6 percent of households would face a tax increase averaging $1,500. For the top one-tenth of one percent of the income distribution, 62 percent of households would benefit by an average amount just under $270,000.

Under a 25-percent top rate on a narrow definition of pass-through income, about 85 percent of the net tax cut would go to the top 1 percent of the income distribution (Table T17-0170). Their average increase in after-tax income would be 1.4 percent or about $21,500. The proposal would cut taxes for 3.5 percent of households, by an average amount of about $5,200. Approximately 1.7 percent of households would face a tax increase averaging $900.

CONCLUSION

We use the TPC microsimulation model of the federal tax system to analyze the impact of several illustrative options for reducing the individual income tax rate on sole proprietorships and other pass-through entities such as partnerships and S-corporations. To focus on the effects of the special pass-through tax rate, we produce estimates relative to a baseline that repeals the individual AMT and implements three ordinary income tax rates of 12, 25, and 33 percent.

We find that applying a 15 percent tax rate on a broad definition of pass-through income would reduce tax revenue by $1.36 trillion over 10 years. Including a plausible level of income shifting, the revenue loss would increase to $1.95 trillion. Raising the rate to 25 percent, or narrowing the definition of pass-through income would reduce the revenue loss. The highest income households would receive the clear majority of the benefits from any of these options.

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