TAX POLICY CENTER
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Preferential Pass-Through Business Tax Rates and Tax Avoidance

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The large (and growing) share of businesses organized as pass-through entities—those that do not pay the corporate income tax but rather pass profits through to owners, who report the income and pay tax on their individual tax returns—has been a sticking point in recent efforts to reform the individual and corporate income taxes. Reforms focused on lowering the 35 percent statutory corporate tax rate have raised concerns about "small businesses" that would not benefit from the lower rate. Some reform plans, such as President Trump's tax plan and the House GOP's tax reform blueprint, have proposed a new lower individual tax rate for pass-through income. Kansas has gone so far as to exempt pass-through businesses from income tax entirely.

Advocates of such proposals argue that they would stimulate employment and the economy. For example, here's President Trump during the 2016 election:

> This year, Congress will consider what may be the biggest tax bill in decades. This is one of a series of briefs the Tax Policy Center has prepared to help people follow the debate. Each focuses on a key tax policy issue that Congress and the Trump administration may address.

"I'll be reducing taxes tremendously, from 35 percent to 15 percent for companies, small and big businesses. That's going to be a job creator like we haven't seen since Ronald Reagan. It's going to be a beautiful thing to watch. Companies will come. They will build. They will expand. New companies will start."

However, the proposals would also create new avenues for tax avoidance, and they would continue to tax corporate investment more heavily than other forms of investment.

HOW ARE BUSINESSES TAXED?

Pass-through income flows through to owners, where most is subject to ordinary income tax rates. Some (such as carried interest) is taxed at the lower capital gains rate, and only some is subject to payroll taxes (called the Self-Employed Contributions Act [SECA] tax for self-employed people).

Corporate income, in contrast, is subject to two levels of taxation: profits are taxed at the corporate level, then dividends and capital gains are taxed again at the shareholder level (albeit at lower rates). Many previous tax reform proposals aimed to tax corporate income the same as pass-through business income. However, although tax reform proposals currently in the works would cut corporate income tax rates, they would also cut pass-through business income tax rates and continue to favor unincorporated businesses compared with corporations.

MIND THE GAP: TAX RATE DIFFERENTIALS AND TAX AVOIDANCE

Taxpayers work hard to take advantage of differences in tax rates. The logic is simple: if wage income is taxed at 33 percent but business income is taxed at 15 percent (as under President Trump's campaign proposal), taxpayers may reduce their tax liability by more than half if they can effectively recharacterize their wage income as business income.

This is exactly what happens with the capital gains tax. Complex schemes generate deductions to shelter current wages and salaries from tax and ultimately generate income in the form of capital gains. Successful tax shelter investments often make no sense but for the tax benefits. As law professor Michael Graetz says: "A tax shelter is a deal done by very smart people that, absent tax considerations, would be very stupid."

Tax shelter investments divert money from productive investments into dubious ones. Careful design and vigilant regulatory response can slow tax avoidance, but the money and time that taxpayers spend on tax avoidance and that regulators spend on policing it is a real loss to society. The brilliant minds that are drawn to the lucrative but socially useless activity of designing tax shelters might otherwise be devoted to inventing products that consumers would want to buy or developing a cure for cancer.

TODAY'S WAGES MAY BE TOMORROW'S "PROFITS"

A big issue with a lower tax rate on pass-through income is that it creates an incentive to earn compensation as pass-through income. In Kansas, where all pass-through income is tax exempt, the highest-paid state employee—Bill Self, coach of the Jayhawks basketball team—earns almost all of his income tax free because he has an LLC (which he created for nontax reasons). And although Kansas has experienced a surge in self-employment since it eliminated taxes on pass-through businesses, there has been no comparable change in overall state employment (indeed, the state's economy has lagged behind its neighbors). Employees likely figured out that they could avoid a lot of tax by becoming consultants or contractors, and such changes have little or no broader economic benefit for the state.

The difficulty of policing the line between wages and profits also exists in the current federal payroll tax. Employee earnings are subject to a 12.6 percent payroll tax (half remitted by employers) up to the Social Security–taxable maximum ($127,200 in 2017) and a 2.9 percent Medicare tax on the entire amount. In contrast, owners of S corporations only pay payroll tax on their "reasonable compensation" and limited partners in partnerships only pay on their "guaranteed payments" for their labor services. But defining those amounts can be controversial and hard to enforce. Politicians Newt Gingrich and John Edwards both famously reported very low compensation to avoid the 2.9 percent Medicare payroll tax on much of their self-employment income. Congressional scorekeepers estimate that tightening the SECA rules that apply to pass-through businesses could raise nearly $140 billion over 10 years. It isn't hard to believe that a 10 or 20 percentage-point difference would substantially worsen avoidance.

Internationally, both Sweden and Finland tax capital income at lower rates than labor income in an effort to spur investment. An unfortunate side effect is that taxpayers recharacterize a significant amount of labor income as capital income to take advantage of the lower rates.