

# Key Elements of the U.S. Tax System

BUSINESS TAXES

What are pass-through businesses?

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**A. Most US businesses are not subject to the corporate income tax; rather, their profits flow through to owners or members and are taxed under the individual income tax. Pass-through businesses include sole proprietorships, partnerships, limited liability companies, and S-corporations. The share of business activity represented by pass-through entities has been rising for several decades.**

Most US businesses are taxed as pass-through (or flow-through) entities that, unlike C-corporations, are not subject to the corporate income tax or any other entity-level tax. Instead, their owners or members include their allocated shares of profits in taxable income under the individual income tax. Pass-through businesses include sole proprietorships, partnerships, limited liability companies and S-corporations.

### TYPES OF PASS-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 (Form 1040). 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 Form 1040. 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.

*Limited Liability Companies (LLCs):* LLCs are companies authorized under state laws. LLC owners, who are called members, may include individuals, corporations, other LLCs and foreign entities; there is no maximum number of members and most states also allow single ownership. Certain activities, such as banking and insurance, are usually disallowed. LLCs may elect to be taxed as a corporation, partnership, or as part of their members' tax return (a "disregarded entity"). Members of disregarded entities are subject to SECA tax on their earnings.

*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 Form 1040. S-corporations can have only one class of stock and cannot have more than 100 shareholders, who must be US citizens or resident individuals. (However, certain estates, trusts, and tax-exempt organizations are also

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allowed.) 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 or “FICA” (Federal Insurance Contributions Act) tax.

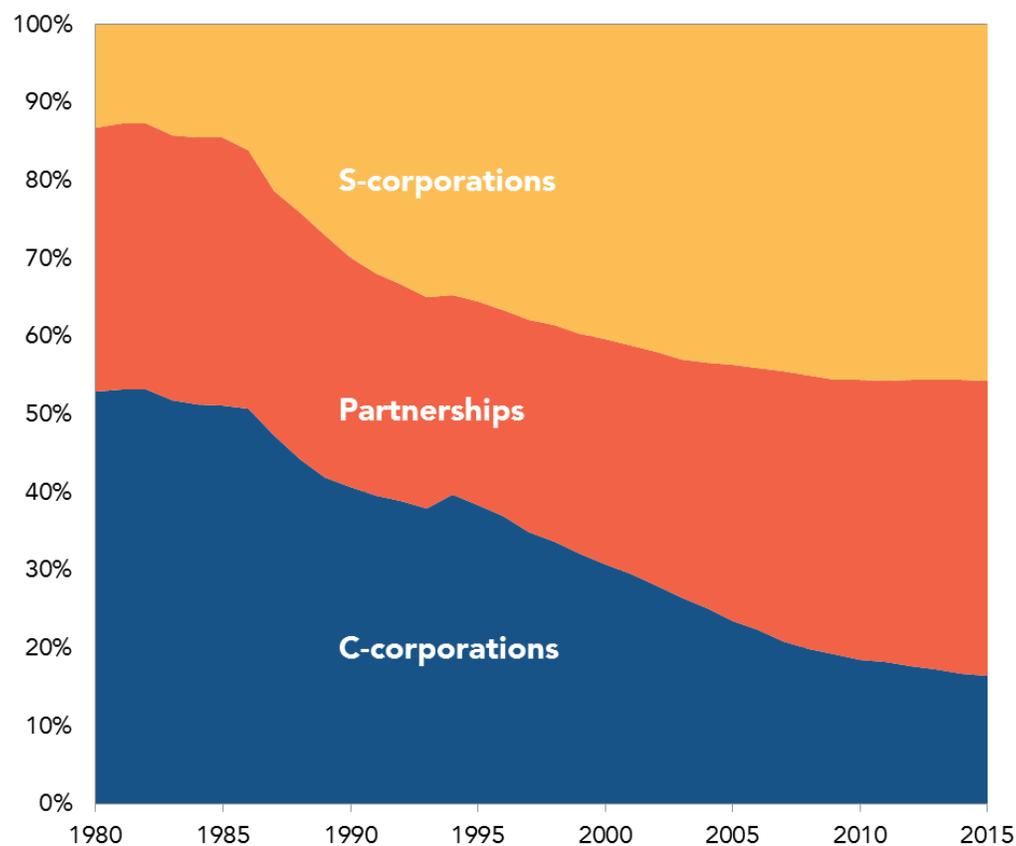
### GROWTH IN PASS-THROUGHS

The share of business activity represented by pass-through entities has been rising, particularly since passage of the Tax Reform Act of 1986 (Plesko and Toder, 2013). Excluding sole proprietorships (which comprise a majority of business tax returns), more than 80 percent of businesses were organized as flow-through entities in 2015—up from 47 percent in 1980 (figure 1). Including sole proprietorships, pass-throughs account for more than 50 percent of total business net income, up from about 22 percent in 1980 (figure 2).

FIGURE 1

## Number of Business Tax Returns by Type

Share of total, tax years 1980–2015



**Source:** Internal Revenue Service. SOI Tax Stats - Integrated Business Database (IBD). Table 1: Selected financial data on businesses, tax year 2015. February 2020.

**Notes:** Excludes nonfarm sole proprietorships, regulated investment companies (RICs), and real estate investment trusts (REITs).

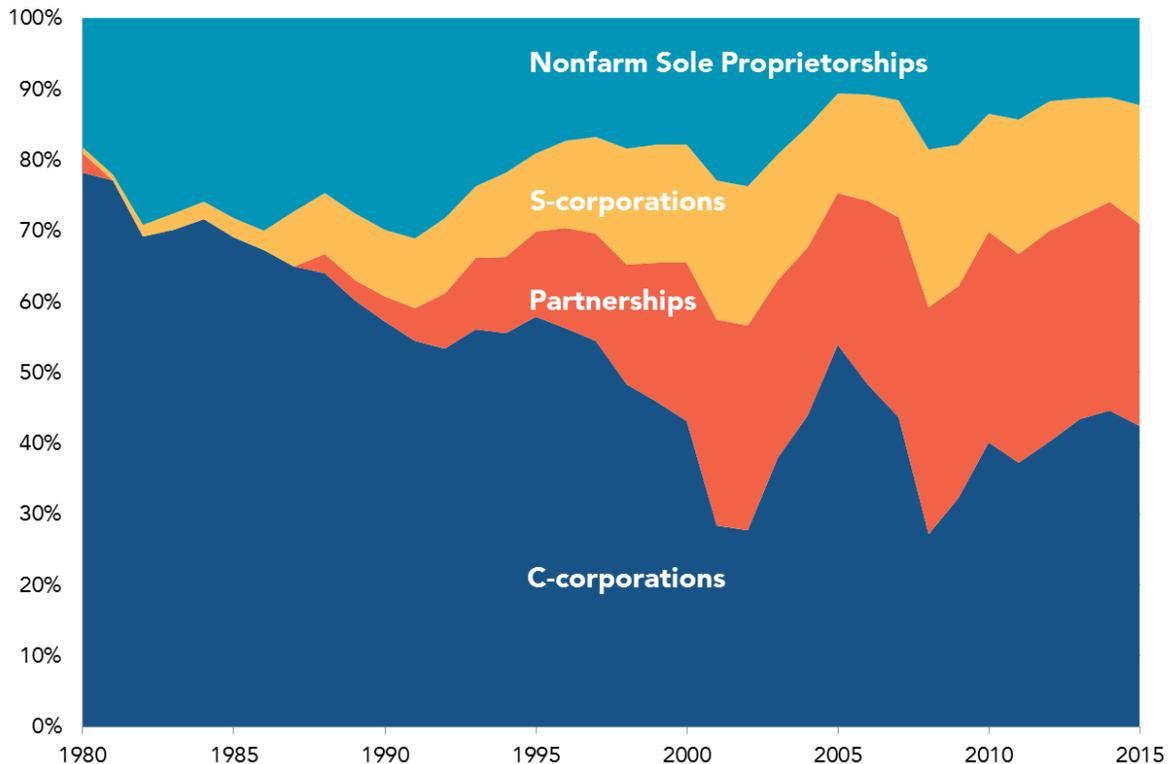
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FIGURE 2

### Net Income (Less Deficit) of Business Tax Returns by Type Share of total, tax years 1980–2015



Source: Internal Revenue Service. SOI Tax Stats - Integrated Business Database (IBD). Table 1: Selected financial data on businesses, tax year 2015. February 2020.

Notes: Excludes regulated investment companies (RICs) and real estate investment trusts (REITs). Partnerships reported a net loss overall in tax years 1981 through 1987.

## PASS-THROUGHS AND THE INDIVIDUAL INCOME TAX

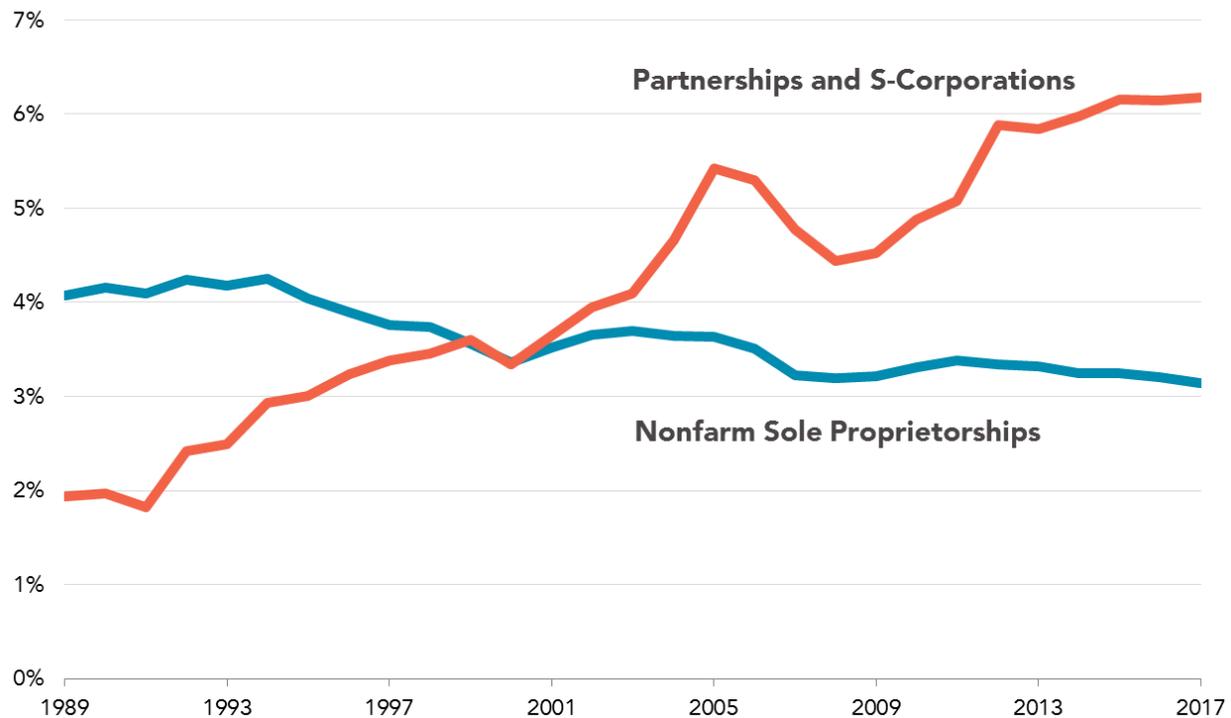
Income from partnerships and S-corporations has been rising as a share of adjusted gross income (AGI), while sole proprietorship income has been declining. In 2017, individuals reported about \$1.03 trillion in net income from all types of pass-throughs accounting for 9.3 percent of total AGI reported on individual income tax returns (figure 3). Nonfarm sole proprietor income has declined modestly as a percentage of total AGI beginning in the 1990s; in 2017, about 26 million returns reported net income of \$346 billion, or 3.1 percent of AGI. In contrast, income from partnerships and S corporations has more than tripled as a share of AGI over the same period; in 2017, 9.1 million returns reported \$680 billion in net income, or 6.2 percent of AGI.

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FIGURE 3

Net Income of Pass-Through Business Tax Returns by Type  
Share of adjusted gross income (AGI), tax years 1989–2017

Source: Internal Revenue Service. SOI Tax Stats Individual Income Tax Returns. Table 1.4: All Returns: Sources of Income, Adjustments, and Tax Items, tax year 2017. September 2019.

Pass-through income is concentrated among higher-income taxpayers. About 85 percent of all pass-through income is reported by taxpayers in the top 20 percent of the income distribution, and more than 50 percent is reported by the top 1 percent of taxpayers. Net income from partnerships and S corporations is even more concentrated—with more than 70 percent reported by the top 1 percent of taxpayers—and accounts for a large fraction of the increased share of income the top 1 percent earns (Cooper et al. 2016).

Updated May 2020

### Data Sources

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### Further Reading

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Plesko, George A., and Eric J. Toder. 2013. "[Changes in the Organization of Business Activity and Implications for Tax Reform.](#)" *National Tax Journal* 66 (4): 855–70.

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