Q. What are pass-through businesses?

A. 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. Pass-through businesses include sole proprietorships, partnerships, and S corporations. The share of business activity represented by pass-through entities has been rising in recent 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 include their allocated shares of profits in taxable income under the individual income tax. Pass-through businesses include sole proprietorships, partnerships, 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. 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 US Department of the Treasury in 1997, limited-liability companies 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 shareholder's 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).

Key Elements of the U.S. Tax System

What are pass-through businesses?

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, more than 80 percent of businesses were organized as flow-through entities in 2014—up from 47 percent in 1980 (figure 1). Pass-throughs now account for more than 50 percent of total business net income, up from about 20 percent in 1980 (figure 2).

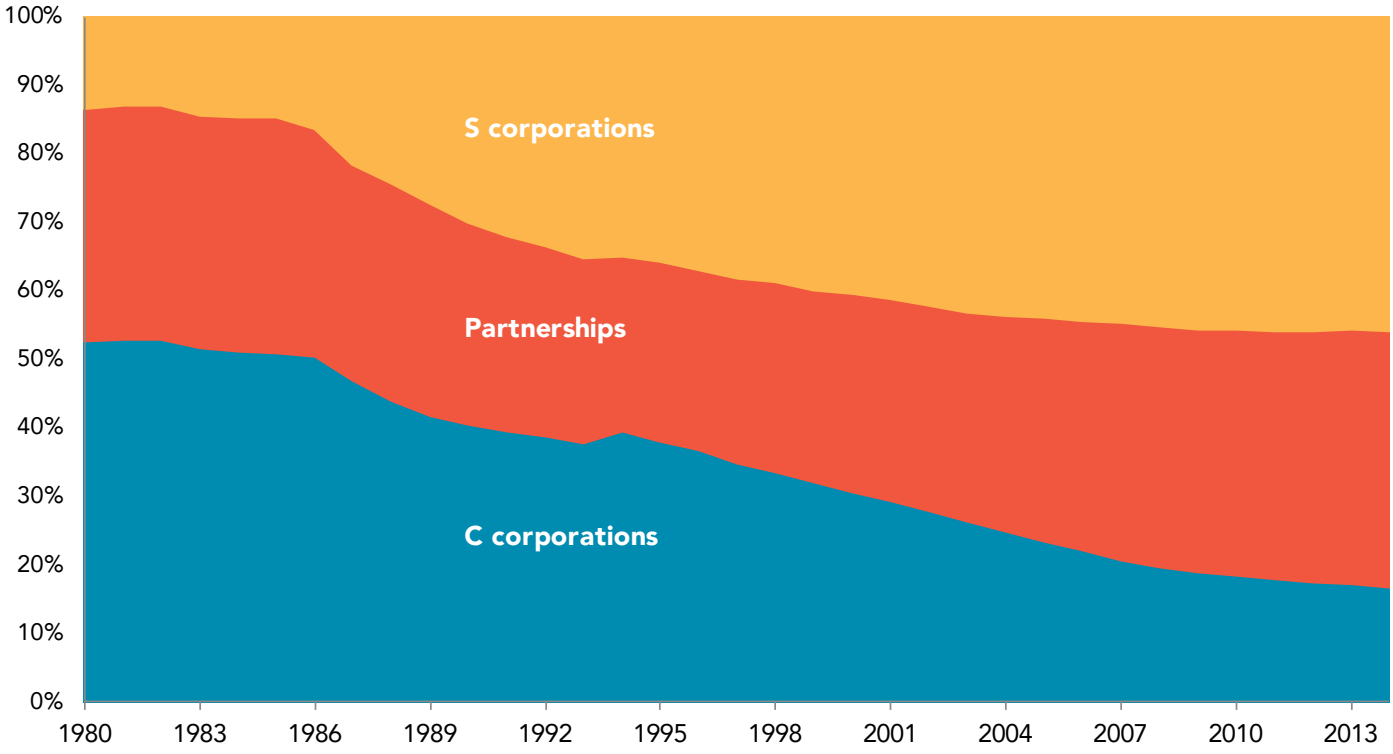
PASS-THROUGHS AND THE INDIVIDUAL INCOME TAX

In 2016, individuals reported about $957 billion in net income from sole proprietorships, partnerships, and S corporations, accounting for 9.4 percent of total adjusted gross income (AGI) reported on individual income tax returns (figure 3). Nonfarm sole proprietor income (reported on Schedule C) has declined modestly as a percentage of total AGI beginning in the mid-1990s. In 2016, 25 million returns reported net income of $328 billion, or 3.2 percent of AGI. In contrast, income from partnerships and S corporations has more than tripled as a share of AGI since the late 1980s. In 2016, 8.7 million returns reported $629 billion in net income from those sources, or 6.1 percent of AGI.

FIGURE 1

Share of Business Returns by Type

1980–2014



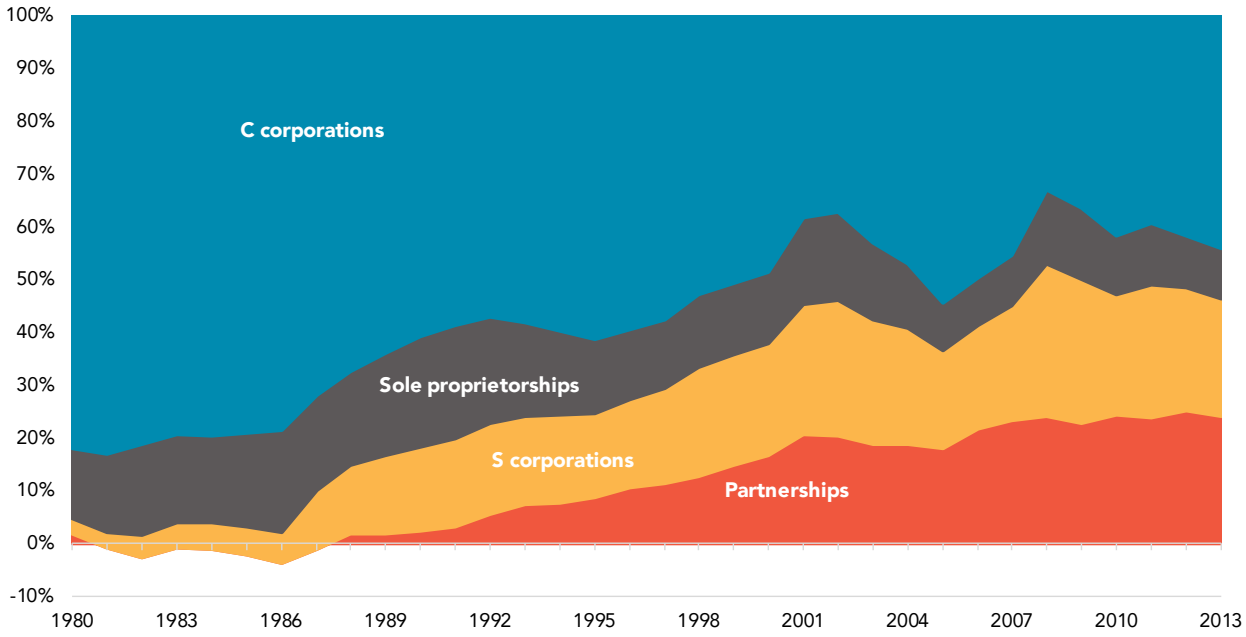
Source: Joint Committee on Taxation (2017).

Key Elements of the U.S. Tax System

What are pass-through businesses?

FIGURE 2

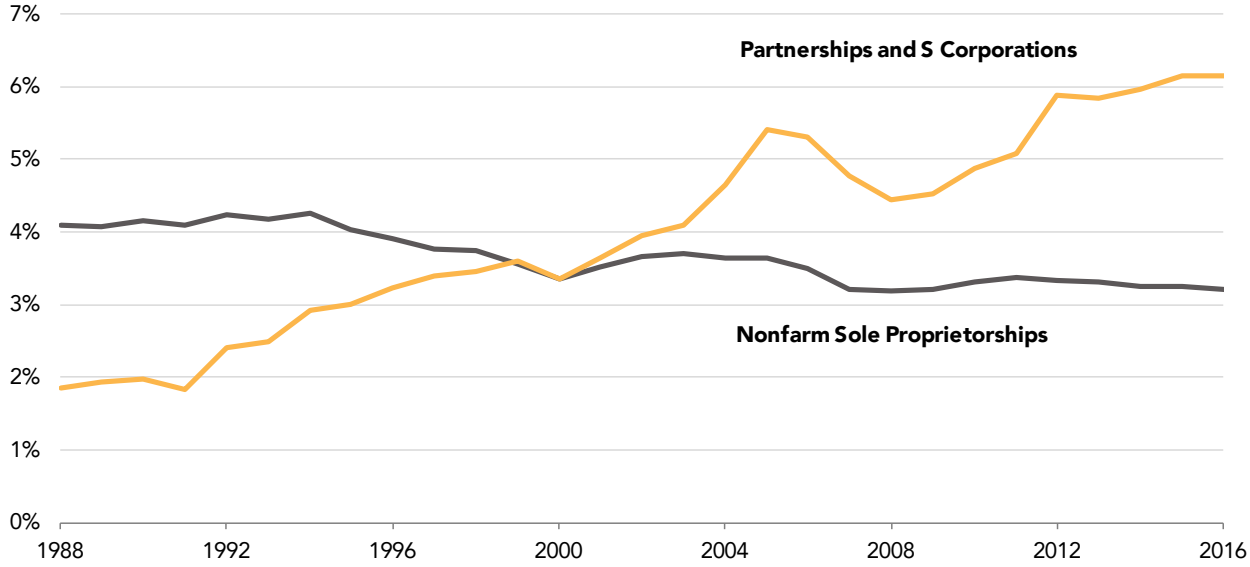
Share of Business Net Income (Less Deficit) by Type
1980–2013



Source: Nelson (2016).
Note: Shares do not include regulated investment corporations and real estate investment trusts. C and S corporation income includes officer compensation.

FIGURE 3

Net Income from Pass-through Businesses as a Percentage of AGI
1988–2016



Source: Internal Revenue Service, *SOI Tax Stats—Individual Income Tax Returns Publication 1304 (Complete Report)*, Table 1.4 (1988–2016).

Key Elements of the U.S. Tax System

What are pass-through businesses?

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).

Data Sources

Internal Revenue Service, Statistics of Income Division. *SOI Tax Stats—Integrated Business Data*. Table 1. "Selected Financial Data on Businesses."

———. *SOI Tax Stats—Individual Income Tax Returns Publication 1304 (Complete Report)*. Table 1.4. "All Returns: Sources of Income, Adjustments, and Tax Items."

Further Reading

Cooper, Michael, John McClelland, James Pearce, Richard Prisinzano, Joseph Sullivan, Danny Yagan, Owen Zidar, and Eric Zwick. 2016. "Business in the United States: Who Owns It and How Much Tax They Pay." *Tax Policy and the Economy* 30 (1): 91–128.

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Nelson, Susan C. 2016. "Paying Themselves: S Corporation Owners and Trends in S Corporation Income, 1980–2013." Working Paper 107. Washington, DC: Office of Tax Analysis, US Department of the Treasury.

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.