

Why the Republican tax plans do nothing to help genuine small businesses

Report • By [Hunter Blair](#) • November 29, 2017

Summary

Republicans have been touting the benefits of their tax plans for “small businesses”—specifically, their proposal to cap taxes on “pass-through” income (income that is not taxed at the business level, but is instead “passed through” entirely to the business owners, who are then responsible for paying personal income taxes on it). The term “small business” conjures up images of neighborhood stores run by hardworking Americans carving out a modest living. But is this really who will benefit from the Republicans’ tax plans? No.

Eighty-six percent of households with pass-through income already pay income tax rates of 25 percent or less (the proposed cap in the House Republican plan—and the current Senate plan would have an even higher cap). These are the archetypal households that most Americans think of when they hear “small business owners.” **None of these households in the bottom 86 percent would benefit** from the House Republican plan.

On the other hand, the **richest 1 percent of households claim 69 percent of pass-through income**. It is abundantly clear that the Republicans’ proposed cap on the taxation of pass-through taxes would disproportionately benefit these top 1 percent. Most people probably don’t think tax cuts aimed at “small business owners” should accrue disproportionately to the richest 1 percent of Americans. Yet this is exactly what the Republican provisions on pass-through income would do.

Introduction

Republican tax plans passed in the House and out of the Senate Finance Committee contain provisions that their defenders claim will help small businesses by lowering top tax rates on “pass-through” income. The House Republican plan includes a new top tax rate of 25 percent on pass-through income. The Senate version of this proposal is different and more complicated, but the broad outcome is the same—a new, lower top tax rate on income that comes from pass-through businesses.

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These changes will not help genuine small businesses, however. The most important thing to remember in this debate is simply that while all small businesses are pass-through businesses, not all pass-through businesses are small businesses. This report fills in some details about the relationship between pass-through businesses and small businesses. Key points are:

- **Taxes on businesses are ultimately paid by households, and this is how their distribution should be assessed.** Looking “through” the business organization to the ultimate owners makes clear that business taxes are one of the most progressive sources of tax revenue, since ownership of business income is heavily tilted toward the top of the income distribution.
- **While all small businesses are pass-through businesses, not all pass-through businesses are small businesses.** Ownership of pass-through income is even more concentrated than ownership of large, traditional corporations (C-corporations, in tax jargon). The top 1 percent claim 69 percent of pass-through income.
- **The Republican proposal for a new 25 percent top tax rate on pass-through businesses won’t help genuine small businesses.** Eighty-six percent of households with pass-through income already pay income tax rates of 25 percent or less, and thereby have nothing to gain from this Republican proposal. Instead, the benefits of this proposal flow to rich pass-through businesses such as hedge funds, law firms, and private equity partners.

Who actually pays taxes on businesses, small or large?

The economic burden of tax is ultimately borne by real people. *Which* people bear that economic burden is referred to by economists as the *incidence* of a tax. Often a tax’s incidence falls someplace unexpected. For example, property taxes are paid by the owners of property, but if a landlord rents an apartment to a tenant, it is almost surely the case that the renter ends up paying (or bearing the incidence of) at least some of the property tax through higher rent payments.

The incidence of taxes on business profits—which are being radically changed in proposed Republican tax plans under debate—is widely assumed to fall entirely on business owners in the short run. In the long run, as markets have time to adjust, the bulk of these taxes’ incidence falls on capital income more broadly, of which business income is just one form. For example, the Congressional Budget Office (CBO), the Department of Treasury Office of Tax Analysis (OTA), and the Tax Policy Center (TPC) all allocate between 75 and 82 percent of the incidence of corporate taxes to capital income.¹ This means that the progressivity of a business tax largely rests on the distribution of ownership businesses. But we should first step back and look into how businesses are structured in the United States.

How are businesses structured and taxed (or not taxed) in the United States?

Large and well-known companies like Apple or Walmart are C-corporations (“C” corresponds to the subchapter in the internal revenue code that governs how they’re taxed). C-corporations are unique among businesses in that they must pay taxes at the business level, paying the corporate income tax on their net income (profits). After they pay tax at the business level, their owners (shareholders) must then pay tax when profits are distributed to them as dividends (or when they sell the company’s stock for a capital gain).

But most businesses are not structured as C-corporations. Businesses are most often structured as one of the various “pass-through” entities—sole proprietorships, partnerships, limited liability companies (LLCs), and S-corporations. Pass-through entities *pay no business-level taxes*. Instead, the income they generated is “passed through” directly to their owners without being taxed at the business level. These owners then must pay tax on this pass-through income when they file their individual income taxes.

Though pass-throughs are all taxed the same way (i.e., only at the individual level, not at the business level), there are some differences among them. Sole proprietorships are unincorporated businesses owned by an individual. Partnerships are unincorporated businesses owned by multiple people or businesses. LLCs are businesses covered by state statutes that allow owners the benefits of limited liability (if the company goes bankrupt, the owners’ assets are shielded from the company’s creditors). And S-corporations are corporations that elect to pass through their net income to shareholders for tax purposes. They pay no business-level tax, but they are limited to 100 shareholders.

Which businesses are tax-advantaged under the current system?

The clearest advantage of organizing as a pass-through business is that income is not “double-taxed.” C-corporations, as discussed above, *are* taxed twice—once at the business level and then again when owners pay individual taxes on distributed profits. But the extent of this “double-taxation” is often wildly overblown, for a couple of reasons. First, at the business level, corporations use loopholes within the tax code to pay far less than the statutory corporate income tax rate of 35 percent. Estimates vary, but the effective rate—that is, the rate corporations *actually* pay after the accountants get involved—appears to be somewhere between 12.5 and 21.2 percent.² Second, at the individual level, corporate stocks are now largely owned by nontaxable shareholders, such as foreign investors and owners of retirement plans. The share of U.S. corporate stock that is held in taxable accounts fell from 83.6 percent in 1965 to 24.2 percent in 2015.³ So, the burden of double-taxation is far lower at both levels than the statutory tax rates would

suggest.

But while the burden of double-taxation on C-corporation owners is not as high as theory would suggest, pass-through income remains relatively tax-advantaged. By one estimate, the combined total effective tax rate in 2011 (including taxes at both the business and individual level) on C-corporations was 31.6 percent (22.7 percent at the business level, 8.9 percent at the shareholder level), while the effective tax rates on partnerships and S-corporations were, respectively, 15.9 and 25 percent.⁴

Why would any firm choose to become a C-corporation?

While the double-taxation of C-corporation owners is far less burdensome than is typically presented, it does lead one to wonder why any firm would register as a C-corporation. There are good reasons to do so, however. For one thing, historically a major benefit of the C-corporate structure is that owners' legal and financial liabilities are limited. Limited liability means that if you own a share of stock and the company goes bankrupt, your personal assets are shielded from the company's creditors. Besides this limited liability (which has become increasingly available to pass-through businesses, as we note below), C-corporations have two other advantages. First, they can dilute ownership by selling as many shares of stock as they want. This makes it possible to raise funds for the firm from literally thousands of different investors, greatly expanding the potential pool of funds available to them. Second, they can appoint managers who have the authority to retain earnings (rather than instantly pass them through to company owners) and make investment decisions.

As laws have changed allowing S-corporations to increase their number of shareholders (eroding one advantage of C-corporations),⁵ these S-corporations have steadily increased their share of all business income. Similarly, starting in 1982, states began expanding the ability of partnerships to gain the benefits of limited liability without incorporating. This has similarly led to a large increase in the share of all business income accounted for by these partnerships.

The overall rise of pass-through entities in recent years stems primarily from this rise in partnerships and S-corporations. In 1980, partnerships accounted for 2.6 percent of business income; in 2012, they accounted for 26.3 percent. S-corporations grew from 0.8 percent of business income in 1980 to 16.1 percent in 2012. Over this same time period, C-corporations fell from 79.3 percent of business income to 47.2 percent and sole proprietorships fell from 17.3 percent of business income to 10.3 percent.⁶

Who owns pass-through businesses?

Pass-through businesses are often characterized as small businesses. While there is a grain of truth to this, it is a very misleading description.

As noted above, while all small businesses are pass-throughs, not all pass-throughs are small businesses. Some pass-throughs are hedge funds, or private equity firms, or real estate development companies, or boutique law firms or physician practices. And these “big business” types of pass-throughs claim the vast majority of pass-through income.

Pass-through income is incredibly concentrated among the richest households, with fully 69 percent of pass-through income accruing to the top 1 percent. That makes pass-through ownership even more tilted to the rich than ownership of C-corporations (45 percent of C-corporation income is earned by the top 1 percent).⁷

Will the new 25 percent pass-through rate proposed by Republicans help small businesses?

Not really. House Republicans have proposed a new top rate on pass-through income of 25 percent, claiming that it will help small businesses. (Again, the Senate plan is more complicated but also lowers the top rate faced by pass-through businesses.) But a 25 percent top tax rate can’t help genuine small businesses, because 86 percent of households with pass-through income *already* pay 25 percent or less.⁸ This means that the House Republican proposal isn’t targeted at small businesses at all, but is instead targeted to help the upper echelons of pass-through business owners.

Why might some genuine small businesses think a 25 percent top rate on pass-through incomes would help them?

Many genuine small businesses may be intrigued by the 25 percent top rate because they incorrectly think that their top income tax rate is higher than this. Besides an abundance of cynical rhetoric, we have a couple of guesses as to what could lead to confusion about the benefits of this new rate.

Many small businesses generate large revenues, but smaller profits—only the profits are taxed

One possible source of confusion is that *revenues* from a business are sometimes confused with net income (profits). Take a married couple who earns all of their income from a small business they own. For this couple, the top 39.6 percent rate would only kick in on taxable income above about \$470,000. It is certainly possible that many genuinely

small businesses generate \$470,000 in sales (or revenues), and if they think this is the relevant metric triggering their tax rate, they could imagine themselves benefiting from the Republican tax plan. But what they need to realize is that it is their *profits*, not their *sales* or *revenue*, that are taxable and hence determine their income tax rate.

For example, say that our married couple's small business brought in gross revenue (sales) of \$500,000, but their expenses (need to hire workers and buy materials) were \$350,000. In this case, the business income passed through to our small business owners would be just \$150,000. That income level already faces a 25 percent income tax rate, so a new rate capped at 25 percent will make no difference in the rate they pay.

Self-employment and state and local taxes can push some small business tax bills over 25 percent—but the Republican tax plans won't change that

Another possible avenue for confusion is the self-employment tax. Social Security and Medicare are funded through payroll taxes. Both employers and employees are assessed 6.2 percent for Social Security (up to a taxable maximum of roughly \$125,000) and 1.45 percent for Medicare. Despite this legal split of tax liability, economists believe that the incidence of payroll taxes eventually falls entirely on workers.

Since a self-employed worker (think of the sole proprietor of a small business) is both employee and employer, households with self-employment income must pay *both* the employee and employer side of the payroll taxes to avoid creating a tax loophole. Turning back to our hypothetical small-business-owning household, one can imagine that the requirement to pay a 15.3 percent *self-employment* tax makes them think that they face a substantially higher *income* tax rate than they actually do. Once the payroll tax is factored in for a small business owner in the 25 percent *income* tax bracket, this household is facing a total effective marginal tax rate of 40.3 percent, which is very close to the top individual income tax rate of 39.6 percent. This household may incorrectly believe that House Republicans are intent on reducing their *overall* taxes through this "small business" proposal. *But the House Republican plan does nothing to cut payroll or self-employment taxes.* This means that our hypothetical small business owners will see no reduction in taxes.

The total tax burden that worries small business owners also includes state and local taxes, but again the Republican tax proposal to lower top federal income tax rates on pass-through income does absolutely nothing to reduce the state and local taxes that these owners face.

Conclusion

Genuine small businesses have nothing to gain from the Republican tax plans currently

under debate. Rich businesses organized as pass-throughs and their patrons in Congress should stop trying to smuggle in benefits for the top 1 percent based on rhetoric about helping these genuine small businesses.

Endnotes

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