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Trump Tax Plan Includes Major Tax Break For Wealthiest Taxpayers

By Chuck Marr and Chye-Ching Huang

A central element of Donald Trump's tax plan,[1] which he's expected to discuss in a high-profile speech in Detroit today,[2] is a special 15 percent tax rate on business income claimed on individual tax returns, known as "pass-through" income. Mr. Trump says it's designed to help small businesses, which he contends shouldn't pay a higher tax rate than large corporations. Mr. Trump, who has proposed a 15 percent corporate tax rate, proposes a pass-through rate of 15 percent as well.[3] The Trump pass-through proposal would be an expensive tax cut that would flow primarily to the wealthiest Americans. That's because more than two-thirds of pass-through business income flows to the highest-income 1 percent of tax filers.

Many businesses, such as law firms, and groups of wealthy investors *choose* to be taxed as pass-through entities instead of as corporations and often do so to lower the overall taxes they owe. In recent decades, many businesses and their owners have reaped sizable tax savings by doing so. A special 15 percent tax rate on pass-through income such as the Trump tax plan proposes would offer them another large tax cut.

We don't know whether Mr. Trump plans to substantially modify his tax plan today, which he unveiled in September 2015. Nevertheless, recent reports indicate that his proposal for lower

[1] "Tax Reform That Will Make America Great Again," as released in September 2015. For more, see James R. Nunns, Leonard E. Burman, Jeffrey Rohaly, and Joseph Rosenberg, "Analysis of Donald Trump's Tax Plan," Tax Policy Center, December 22, 2015, http://www.taxpolicycenter.org/publications/analysis-donald-trumps-tax-plan/full.

[2] Richard Rubin, "Business Groups Sue U.S. Government Over Tax-Inversion Rules," *Wall Street Journal*, August 4, 2016, https://t.co/UQWIZL0bxq.

[3] The Trump plan describes this provision in the following way: "[The proposal's 15 percent corporate tax rate] cannot be for big business alone; it needs to help the small businesses that are the true engine of our economy. Right now, freelancers, sole proprietors, unincorporated small businesses and pass-through entities are taxed at the high personal income tax rates. This treatment stifles small businesses. It also stifles tax reform because efforts to reduce loopholes and deductions available to the very rich and special interests end up hitting small businesses and job creators as well. The Trump plan addresses this challenge head on with a new business income tax rate within the personal income tax code that matches the 15% corporate tax rate to help these businesses, entrepreneurs and freelancers grow and prosper."

corporate and pass-through tax rates will remain a central element of his plan.[4] (Even if he lowers the rate for pass-through entities but not all the way down to where he would set the corporate rate, that still would be costly and have a regressive effect, offering tax cuts primarily for those at the top of the income scale rather than for what most people consider "small businesses.") Policymakers cannot easily prevent the tax avoidance that setting the pass-through tax rate lower than regular individual income tax rates would spur. As the Urban-Brookings Tax Policy Center has noted, effective measures to prevent such tax avoidance would be very hard to design and enforce.[5]

"Pass-throughs" are not synonymous with "small businesses." Pass-through income is claimed by business entities that aren't subject to the corporate income tax, which currently has a top statutory rate of 35 percent (though most corporations pay an effective tax rate considerably lower than 35 percent). Pass-through income is business income that "passes through" the business and is instead reported on the individual tax returns of the business owners and taxed at the owners' tax rates. Partnerships, such as law firms and groups of wealthy investors, sole proprietorships, and S corporations are types of pass-throughs. S corporations are similar to traditional C corporations (those that face the corporate income tax rate) though they can choose to be taxed as a pass-through if they have 100 or fewer shareholders. Despite this limit on the number of shareholders, pass-throughs nonetheless can be very large businesses.

In fact, most pass-through income is earned by a very small share of businesses with quite large profits. In 2012, the 0.4 percent of S corporations with total receipts of more than $50 million (and average receipts of $161 million) earned 40 percent of all S corporation income. And the 0.3 percent of partnerships with receipts of over $50 million (with receipts averaging $375 million apiece) earned more than 70 percent of partnership income.[6]

Pass-through income is highly concentrated at the top. Pass-through income is highly concentrated among the wealthiest Americans. Thus, the benefit of Mr. Trump's proposed lower rate for so-called "small business" pass-through income would flow disproportionately to wealthy filers.

In 2015, a group of economists from the Treasury Department, the University of Chicago, and the University of California at Berkeley confirmed the extreme concentration of pass-through income.[7] They found that 45 percent of dividends from corporations subject to the standard corporate tax rate flow to the top 1 percent of households. Even more striking was their finding that 69 percent of pass-through income flows to the top 1 percent.[8] (See Figure 1.)

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[4] Rubin, 2016. The article notes that "Republican presidential candidate Donald Trump will use an economic policy speech on Monday to reiterate his support for a single top business tax rate that would apply to corporations and to businesses that pay taxes through their owners' individual returns, a campaign adviser said."

[5] Nunns, Burman, Rohaly, and Rosenberg, p. 5.

[6] Joint Committee on Taxation tabulations using IRS Statistics of Income data. See Tables 4 and 5 in Joint Committee On Taxation, "Background on Business Tax Reform," April 22, 2016, https://www.jct.gov/publications.html?func=startdown&id=4903.

[7] Michael Cooper *et al.*, "Business in the United States: Who Owns it, and How Much Do They Pay?," National Bureau of Economic Research, October 2015, http://www.nber.org/papers/w21651.

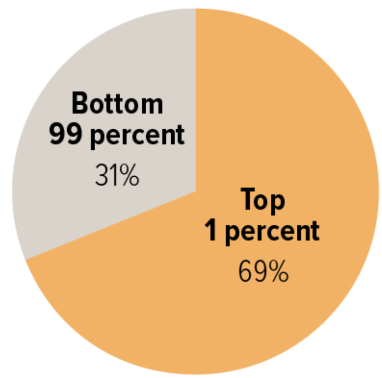
[8] *Ibid.,* p. 3.

About half of the 400 highest-income Americans report S corporation or partnership income.[9] In 2013, the 400 highest-income American households made an average of $94,448,000 each from net S corporation and partnership income — a full one-fifth of these richest tax filers' income.[10]

FIGURE 1

Top 1 Percent Receives Most Pass-through Income

Share of pass-through income received by income group



Source: Cooper *et al*., "Business in the United States: Who Owns it and How Much Tax Do They Pay?," National Bureau of Economic Research, October 2015

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Under the Trump plan, wealthy individuals who claim pass-through income would receive tax cuts regardless of their wealth, the size or type of their business, or their role in its operation. Indeed, most of the partnership income that the top 1 percent of filers earn comes from finance and holding companies, not the sort of bricks-and-mortar businesses that the term "small business" conjures.[11]

Further, many taxpayers who would benefit from the lower tax rate on pass-through income are simply passive investors. For example, a wealthy individual who has invested in a real estate partnership but isn't involved in decisions on buying and selling properties would nevertheless get a tax cut under this proposal.

Pass-through income already often enjoys a major tax advantage. The current tax code often creates strong incentives for companies to organize as pass-through entities, allowing their investors to avoid corporate-level taxes. Moreover, many can choose not to establish as a corporation for tax purposes while still being able to enjoy classic corporate limited-liability protection.[12]

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[9] 237 such filers reported net S corporation or partnership income in 2009, the latest year for which the IRS reported these data. See Internal Revenue Service, "The 400 Individual Income Tax Returns Reporting the Largest Adjusted Gross Incomes Each Year, 1992–2013," July 12, 2016, https://www.irs.gov/pub/irs-soi/09intop400.pdf.

[10] *Ibid*., p. 5.

[11] Cooper *et al.* find, "Of the 69.0% of partnership income that accrues to top-1% households, 36.6 of those percentage points accrue from partnerships in the finance and holding company industry and another 16.0 accrue from partnerships in the professional services industry. In contrast, only 0.6 percentage points accrue from the accommodation and food service industry, a traditional 'mom-and-pop' industry. Taking into account all AGI [adjusted gross income] percentiles, nearly half (48.7%) of partnership income earned by individuals accrues from partnerships engaged in finance and company holding." (p. 13).

[12] Beyond risking their investment, the owners cannot be held liable for the debts or other legal obligations of the business.

The relative tax benefits of pass-through versus corporate taxation depend on a number of factors,[13] but high-income investors are often better off from a tax perspective operating their businesses as a pass-through.

This tax advantage already costs billions of dollars in forgone revenue. Over recent decades, tax benefits for pass-throughs have been enlarged, while the requirements that businesses must meet to qualify for pass-through treatment have been loosened. Not surprisingly, the share of businesses organizing as pass-throughs — and the share of receipts going to those entities — has increased dramatically. In 1985, 49 percent of businesses were organized as pass-throughs, and they accounted for 9 percent of business receipts. By 2012, 80 percent of businesses were pass-throughs, accounting for 36 percent of all business receipts.[14]

The shift away from C corporations to pass-throughs has resulted in roughly $100 billion less in annual federal tax revenue than if the composition of businesses had remained at the 1980 proportion of C corporations to pass-throughs, according to the analysis cited above by the Treasury Department and academic economists.[15]

The proposed cut in the pass-through rate would likely spur large-scale tax avoidance. Many S corporation shareholders receive both wages from the company and a share of the company's profits, but pay payroll tax only on their wages. This gives them an incentive to underreport the share of their income that comes from wages and overstate the share that is pass-through business income, in order to substantially reduce their payroll taxes.[16] While individuals who are both employees and shareholders of an S corporation are supposed to report "reasonable" compensation to themselves, many do not, as various investigations have documented.[17] This tax-avoidance strategy received significant media scrutiny when former lawmakers John Edwards and Newt Gingrich were found to be using it to shrink their payroll tax liabilities.

Mr. Trump's plan would set the individual tax rate on pass-through business income at 15 percent, ten percentage points below his proposed 25 percent top tax rate on ordinary income. If the ability to escape a 2.9 percent payroll tax (the payroll tax rate that would otherwise apply) encourages wealthy pass-through business owners to reclassify their labor earnings as "business" income, a *ten percentage-point tax-rate differential* would provide a far greater incentive for such taxpayers to try to classify more of their ordinary earnings as pass-through business income.

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13 The primary factors are the marginal personal and corporate tax rates that investors would face, the tax rates for dividends and long-term capital gains, and the length of time the investments are expected to be held (since investors in C corporations benefit from the ability to defer those individual-level taxes until the gains on those investments are realized).

14 These figures exclude sole proprietorships, which accounted for only 4 percent of all business income in 2012. IRS Statistics of Income, https://www.irs.gov/uac/soi-tax-stats-integrated-business-data.

15 Cooper *et al.*, p. 21.

16 The taxes in question are the Medicare tax which totals 2.9 percent (1.45 percent for employer and 1.45 percent for the employee).

17 Chuck Marr, Chye-Ching Huang, and Joel Friedman, "Tax Expenditure Reform: An Essential Ingredient of Needed Deficit Reduction" Center on Budget and Policy Priorities, February 28, 2013, http://www.cbpp.org/research/tax-expenditure-reform-an-essential-ingredient-of-needed-deficit-reduction.

As the Urban-Brookings Tax Policy Center noted in its analysis of the Trump tax plan:[18]

> Establishing a top rate on pass-through business income that is 10 percentage points below the top rate on wages would create a very strong incentive for wage earners to become independent contractors, who would be taxed at the preferential pass-through business rates. Congress could impose strict rules in an attempt to limit such changes in worker status, but the boundary is quite difficult to enforce under current law and would be even harder to police if the Trump proposal were enacted.

Kansas has already seen the effects of adopting ill-advised tax cuts for pass-throughs. As part of an aggressive set of tax cuts, in 2012 the state exempted pass-through income from all state income taxes. As the Center on Budget and Policy Priorities' Nicholas Johnson and Michael Mazerov warned in 2012 that this was a poorly targeted idea that would spur tax avoidance:[19]

> Since no state has ever offered this provision, it is hard to know what […] avoidance strategies may be possible, but there is little reason to doubt that tax lawyers and accountants will seek to exploit it — that is, to use it to identify additional opportunities to avoid paying taxes on income, particularly investment income, that they would otherwise owe. Of course, only those taxpayers who can afford high-priced lawyers and accountants will benefit from this.

Analysts across the political spectrum acknowledged this risk. Joseph Henchman of the Tax Foundation warned that excluding pass-through income from taxation would act as "an incentive to game the tax system without doing anything productive for the economy."[20]

The Kansas experience provides a cautionary tale in another respect as well. Proponents of the Kansas tax cut that featured the elimination of taxes on pass-through entities claimed that it would ignite strong economic growth. Instead, Kansas' economy has performed less well than the national economy since the tax cut was enacted.[22] Moreover, proponents of the Trump plan, some of whom were among the principal individuals claiming the Kansas tax-cut plan would do wonders for the state's economy, are now making similar types of claims regarding the Trump tax proposals.[23]

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[18] Nunns, Burman, Rohaly, and Rosenberg.

[19] Nicholas Johnson and Michael Mazerov, "Proposed Kansas Tax Break for 'Pass-Through' Profits is Poorly Targeted and Will Not Create Jobs," Center on Budget and Policy Priorities, revised March 26, 2012, http://www.cbpp.org/research/proposed-kansas-tax-break-for-pass-through-profits-is-poorly-targeted-and-will-not-create.

[20] Joseph Henchman, "Kansas May Drop Pass-Through Exclusion After Revenue Projections Miss Mark Again," Tax Foundation, April 30, 2015, http://taxfoundation.org/blog/kansas-may-drop-pass-through-exclusion-after-revenue-projections-miss-mark-again.

[22] Michael Mazerov, "Kansas' Tax Cut Experience Refutes Economic Growth Predictions of Trump Tax Advisors," Center on Budget and Policy Priorities, August 8, 2016, http://www.cbpp.org/research/federal-tax/kansas-tax-cut-experience-refutes-economic-growth-predictions-of-trump-tax.

[23] *Ibid.*

Update, October 10, 2017: We've deleted material from this paper that was based on information released by Kansas Governor Sam Brownback's administration that later proved inaccurate.