

Econ 101: Taxing Pass-Through Businesses

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Meet your instructors...



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Econ 101: Taxing Businesses

Today: Pass-Through Firms

March 28: Multinational Corporations

Overall Objective: You will leave with the knowledge and confidence you need to make sense of business taxation and advise your bosses in this year's high-stakes debate.

Previous Briefings:

- September 27, 2024: Understanding Tax Policy ([recap](#); [slides](#))
- October 18, 2024: The Promise of Equitable and Pro-Growth Tax Reform ([recap](#); [slides](#))

Outline for today

- Basics
- Distribution & Economics
- Special Provisions
 - Section 199A
 - Payroll Taxes
 - Carried Interest
- Complexity & Enforcement
- Q&A

Basics

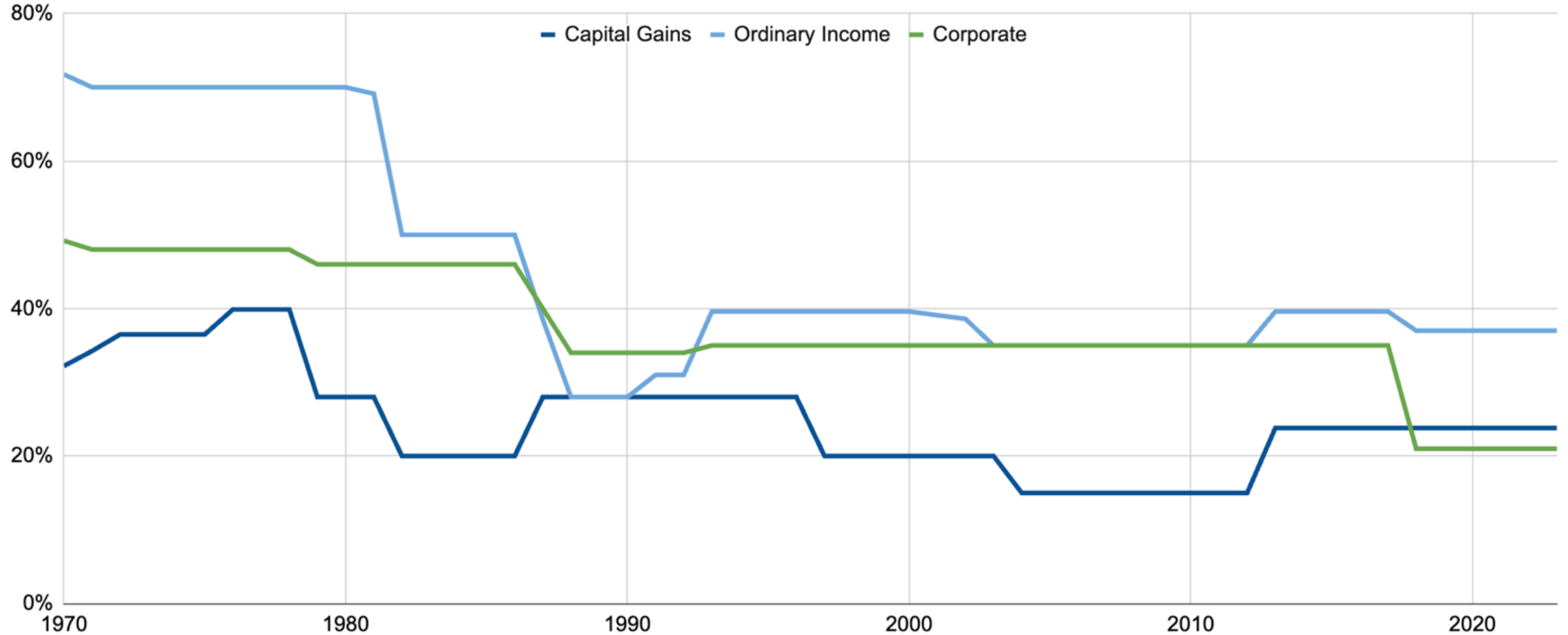
What is a pass-through business?

- Every U.S. company other than a C corporation
 - C corp examples: Apple, AT&T, Chevron, Eli Lilly, Microsoft, Visa, Walmart
 - Pass-through examples: Blackstone, Fidelity, KKR, Trump Org, Uline, X
- Businesses' profits (and losses) are “passed through” to the owners, who pay taxes on the business via their personal income tax (progressive marginal rates from 10% to 37%)
 - Mostly self-reported
 - Can also deduct expenses
- C corporations, in contrast, pay a corporate income tax at the entity level (21%), and then C-corporation shareholders generally pay a second tax if and when they receive a dividend (or sell their stock for a “capital gain”)

What are the different types of pass-throughs?

- Sole proprietorships
 - Single person or married couple
- S corporations
 - Fewer than 100 shareholders, all domestic persons; one class of shares
 - Tax attributes allocated uniformly based on capital contributions
- Partnerships
 - Includes general partnerships, limited partnerships, limited liability partnerships, and **limited liability companies**
 - Can be owned by C corps, S corps, trusts, foreigners, and other partnerships; many possible types of shares
 - Tax attributes allocated flexibly based on partnership agreement

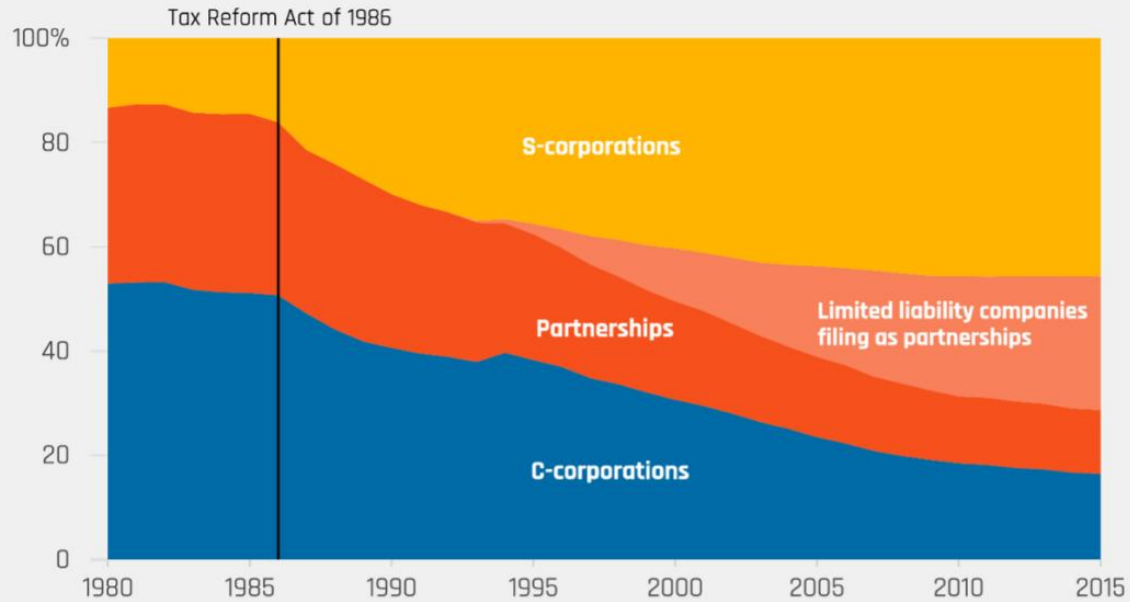
Top tax rates over time



Source: Tax Policy Center

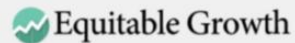
Pass-through businesses are increasingly common in the United States

Number of tax returns filed by two types of pass-through businesses, relative to returns filed by C-corporations, 1980-2015



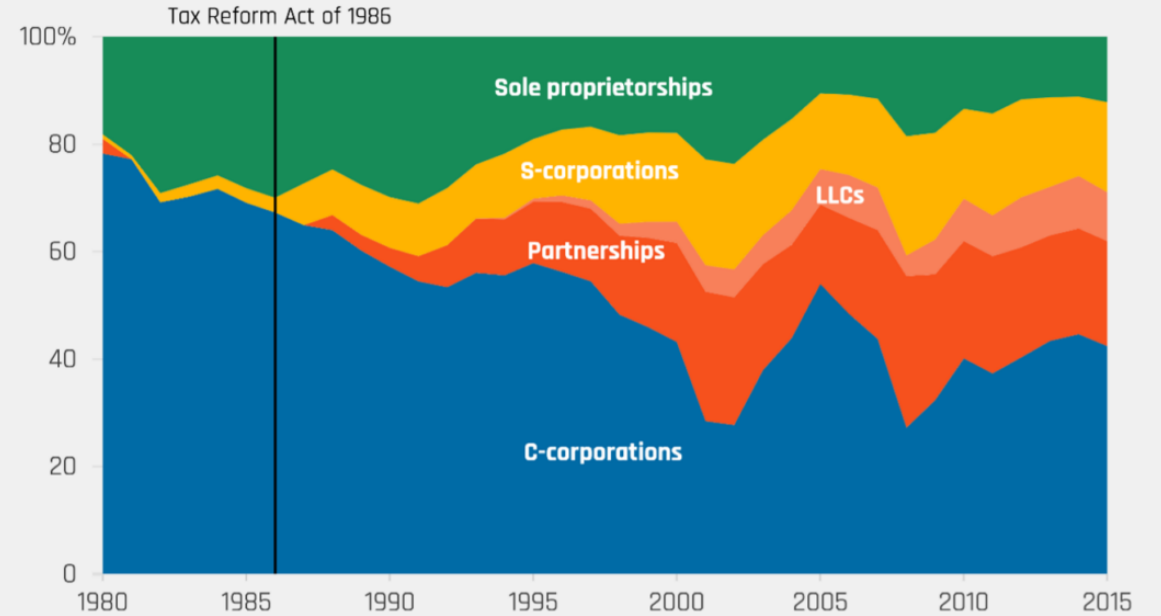
Source: Internal Revenue Service, "SOI Tax Stats - Integrated Business Data" [2023], Table 1, available at <https://www.irs.gov/statistics/soi-tax-stats-integrated-business-data>.

Note: The LLCs in the chart are those that were treated as partnerships for tax purposes, the most common form of filing status for multi-owner LLCs. But note that in certain cases an LLC can instead elect to be treated as a S-corporation, C-corporation, or sole proprietorship.



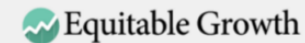
Growth in income of pass-through businesses has outpaced traditional C-corporations over recent decades

Share of net income (less deficit) by business type, 1980-2015



Source: Internal Revenue Service, "SOI Tax Stats - Integrated Business Data" [2023], Table 1, available at <https://www.irs.gov/statistics/soi-tax-stats-integrated-business-data>.

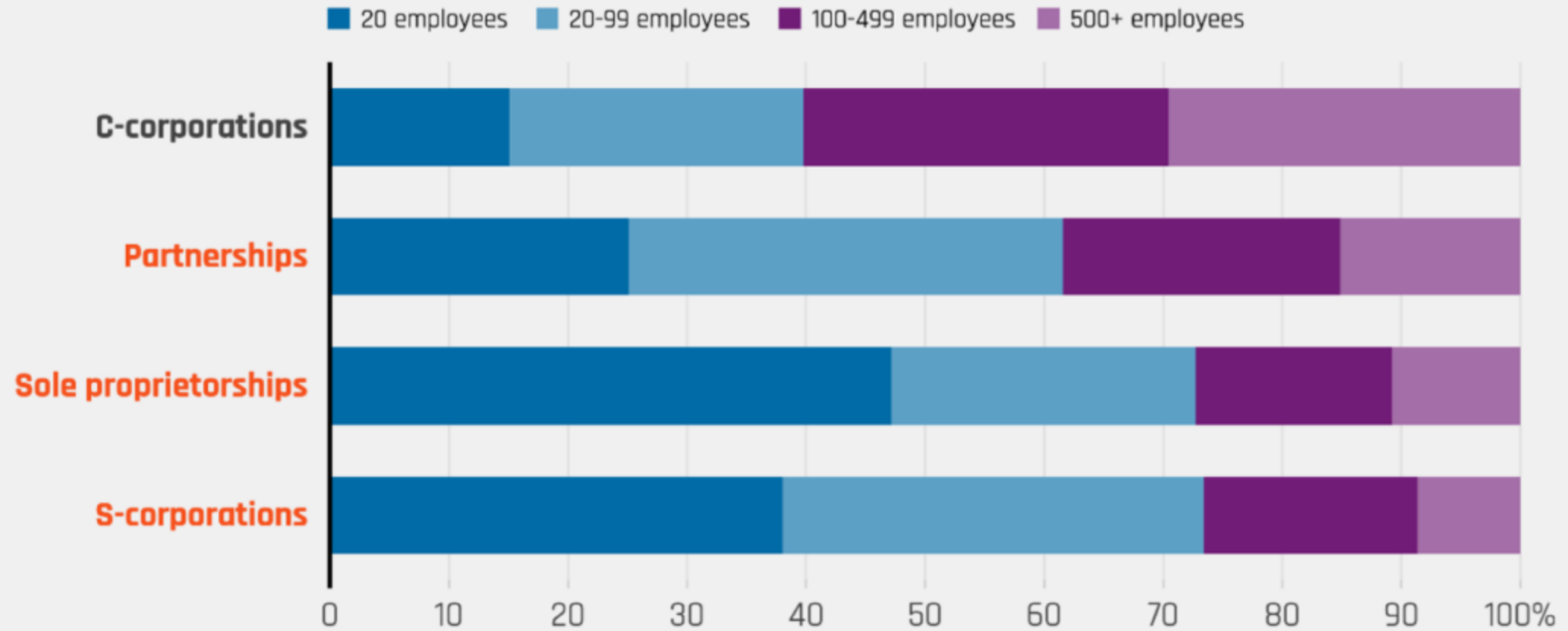
Note: Partnerships reported a loss in 1981 through 1987. The LLCs in the chart are those that were treated as partnerships for tax purposes, the most common form of filing status for multi-owner LLCs. But note that in certain cases an LLC can instead elect to be treated as a S-corporation, C-corporation, or sole proprietorship.



Distribution & Economics

Not all pass-through businesses are small businesses

Distribution of pass-through and corporate employment by firm size, 2021

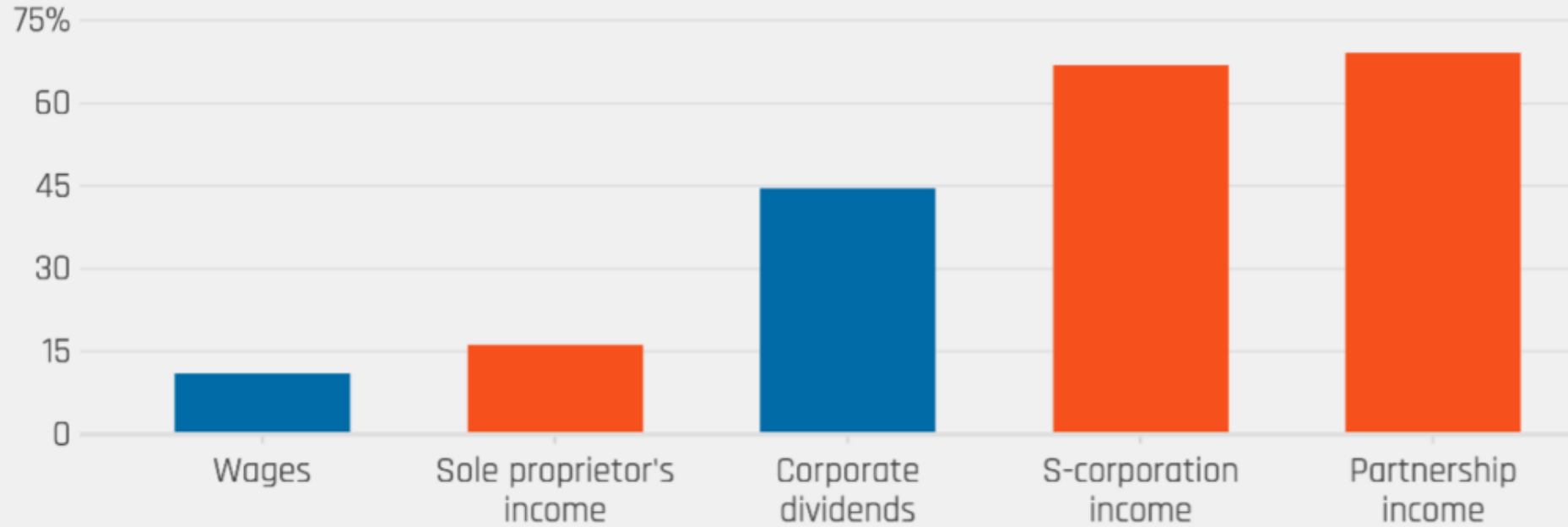


Source: "County Business Patterns: 2021 [Census Bureau, 2023], available at <https://www.census.gov/data/datasets/2021/econ/cbp/2021-cbp.html>; Kyle Pomerleau, "An Overview of Pass-through Businesses in the United States" [Tax Foundation, 2015], available at <https://taxfoundation.org/research/all/federal/overview-pass-through-businesses-united-states/>.

Note: Pass-through businesses are labeled orange.

The top 1 percent of U.S. income earners captures a disproportionate share of pass-through income

Share of income type accruing to tax-filing units in the top 1 percent of U.S. adjusted gross income, 2011

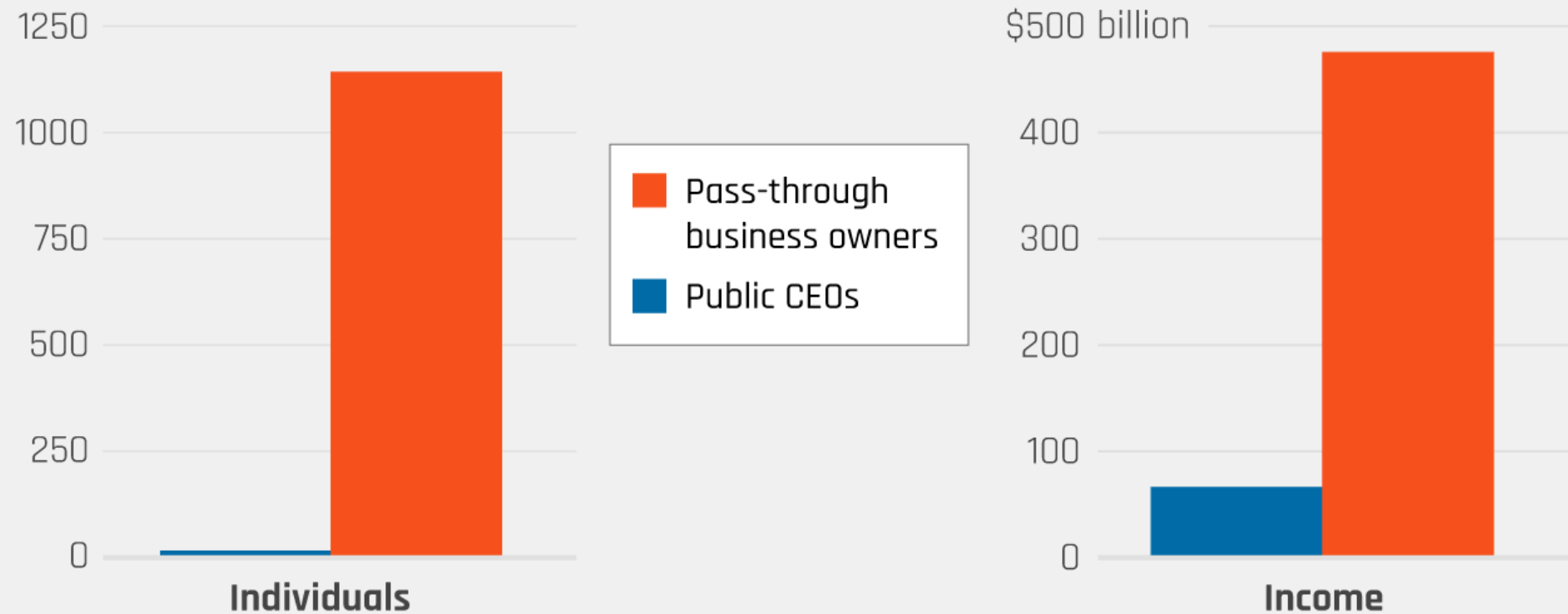


Source: Supplemental data for Figure 6a from Michael Cooper and others, "Business in the United States: Who Owns It and How Much Tax Do They Pay?" [Tax Policy and the Economy, 2016], available at <https://zidar.princeton.edu/document/13>; "Wages" bar from Column E, Row 83 of Table B2 in supplemental and updated data [March 2024] by Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998" [Quarterly Journal of Economics, 2003], available at <https://eml.berkeley.edu/~saez/TabFig2022.xlsx>.

Note: Pass-through businesses are labeled in orange. The top 1 percent in 2011 included those who earned more than \$361,034 (or \$469,720 in 2022 dollars). See Table A6 [nominal and real], Column R, Row 104 in <https://eml.berkeley.edu/~saez/TabFig2022.xlsx>.

Pass-through business owners account for a much larger share of people and income in the top 1 percent than public company executives

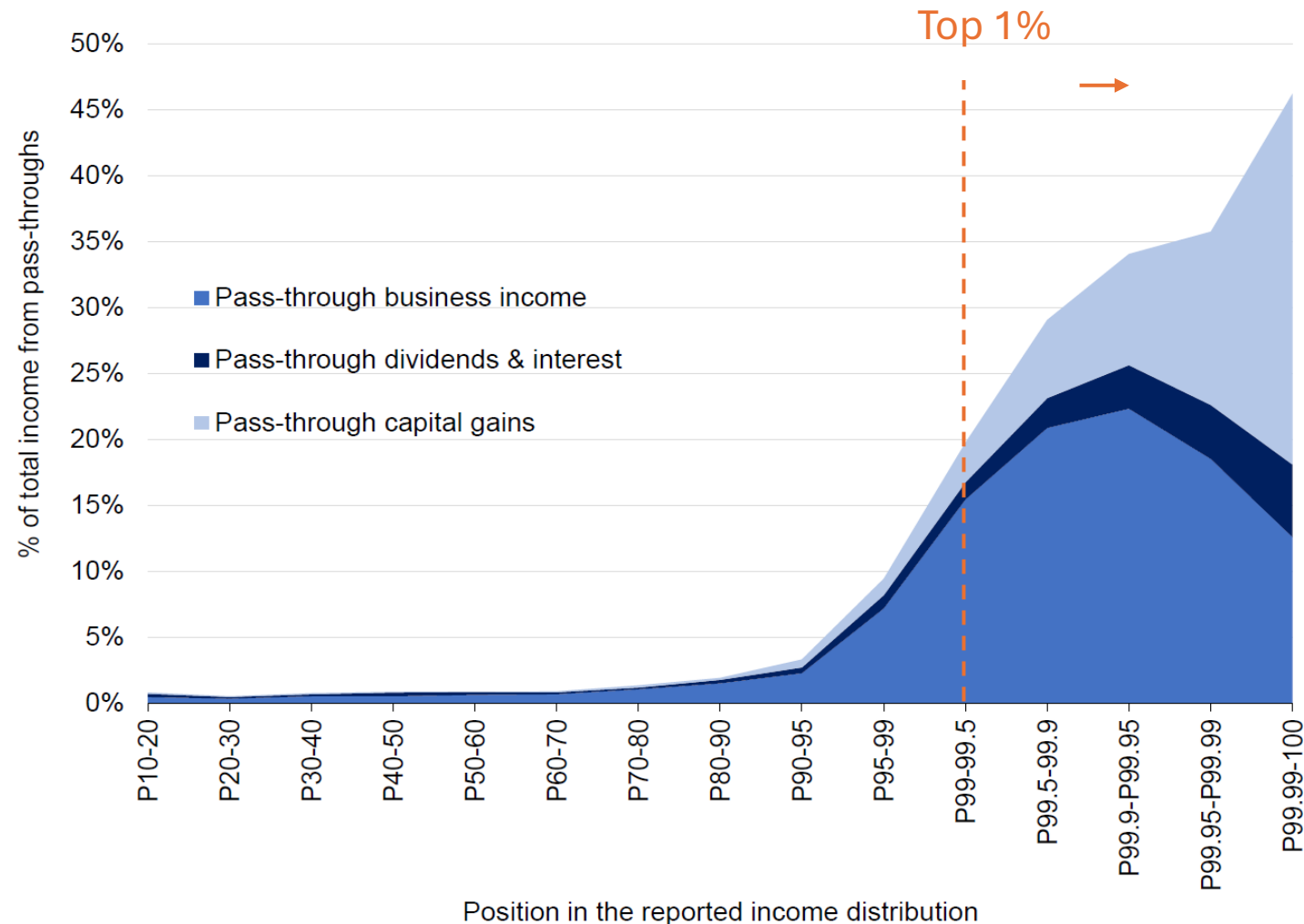
The number of individuals (thousands) and income (billions of dollars) accounted for by public company executives and pass-through business owners in the top 1 percent in the United States, 2014



Source: Matthew Smith and others, "Capitalists in the Twenty-First Century," *The Quarterly Journal of Economics* [134] [4] [2019]: 1675–1745, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3340159.

Partnerships and personal income tax compliance

- Pass-through income highly concentrated at the top of the income distribution



Source: John Guyton and others, “Tax Evasion at the Top of the Income Distribution: Theory and Evidence” Working Paper 28542 (National Bureau of Economic Research, 2023), available at <https://www.nber.org/papers/w28542>.

Partnership income by industry

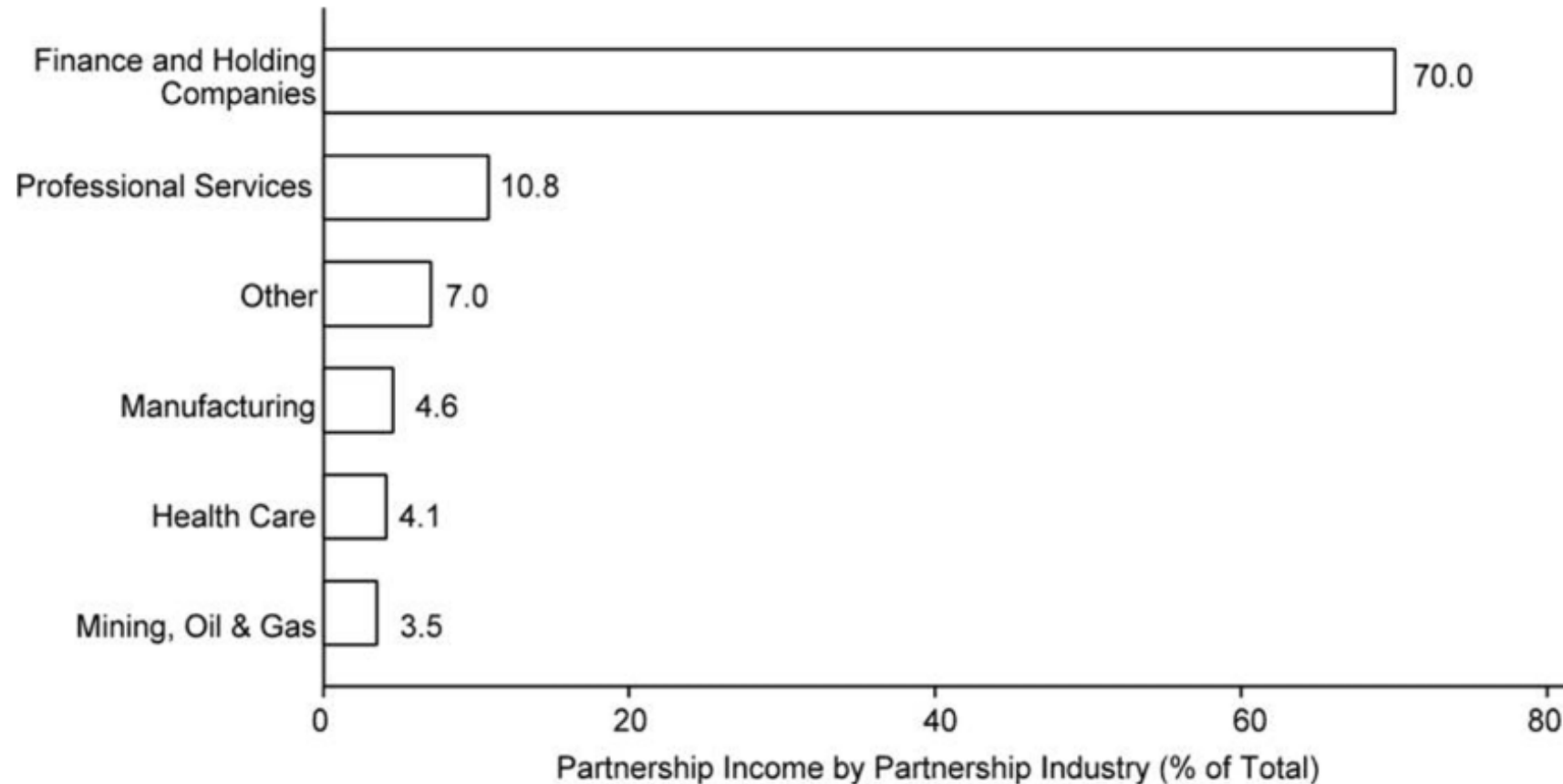
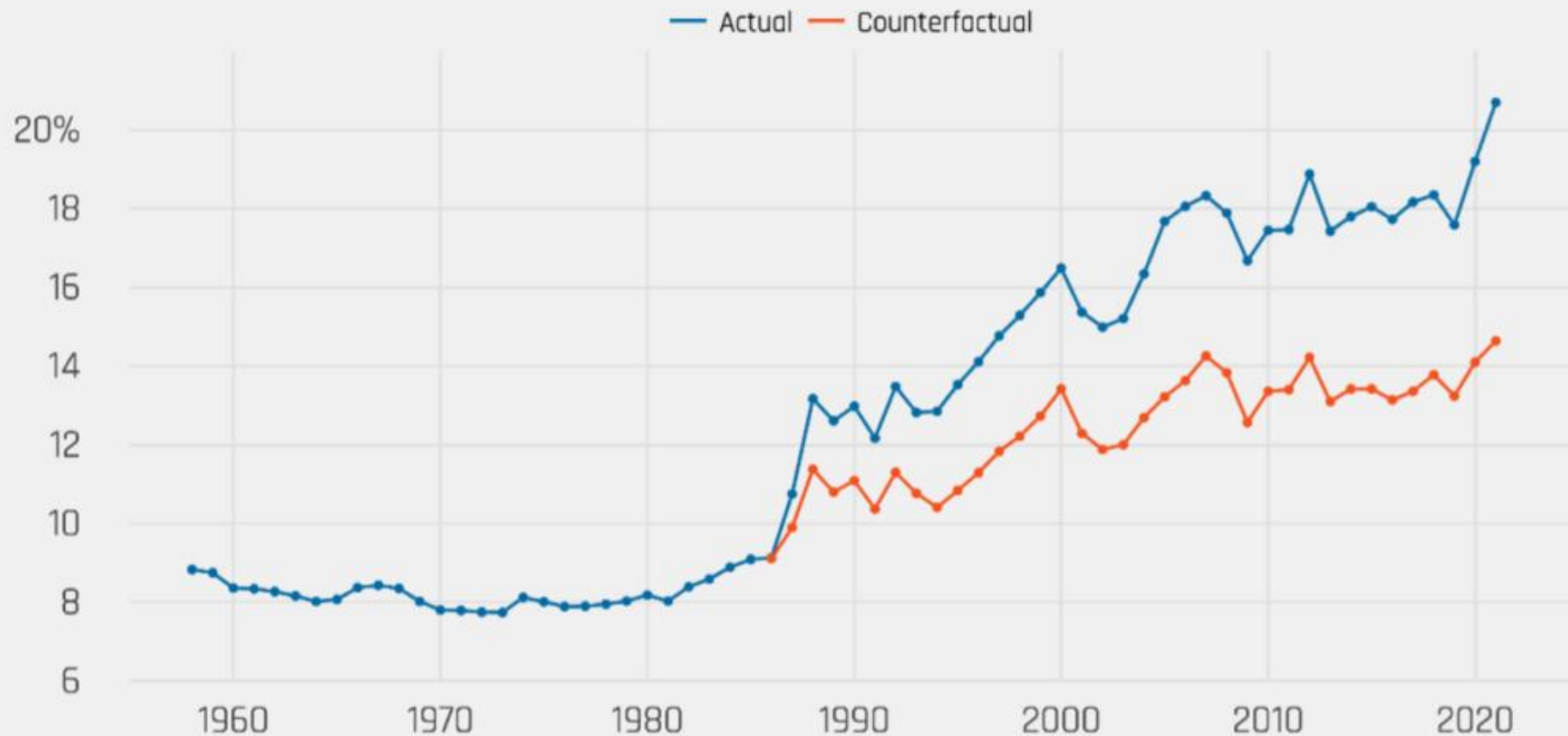


Fig. 4. Distribution of partnership income by industry

Source: Michael Cooper and others, “Business in the United States: Who Owns It and How Much Tax Do They Pay?,” *Tax Policy and the Economy* 30 (1) (2016), available at <https://www.journals.uchicago.edu/doi/full/10.1086/685594>.

Rise of pass-throughs contributed to a large increase in U.S. inequality

The share of income accruing to the top 1 percent in actuality, compared to if the income flow to pass-throughs had not increased from 1985 levels



Source: Update by Owen Zidar of Cooper and others, "Business in the United States: Who Owns it and How Much Tax Do They Pay?" Working Paper [National Bureau of Economic Research, 2015].

Economic effects – business form

- [Emerging research finds](#) that dominance of pass-throughs has negative efficiency effects, keeping businesses artificially small and capital constrained
- The U.S. had more than 7,000 public firms in 1996, and in 2020 it had less than 4,000
 - Less SEC regulation, less financial reporting, more concentrated ownership
 - No access to public capital markets

Pass-through employment and profits

- About 25% of pass-through net income is portfolio income: dividends, interest, rents, royalties
 - Closer to 40% for business owners in the top 1% of the distribution
 - Higher if include capital gains
- Almost all partnership income (particularly that owned by the top 1%) goes to finance, insurance and real estate
- Yet, finance and real estate account for about 6% of partnership employment

Economic effects – workers

- Do business owners pass tax costs/benefits on to workers?
- Short answer: Not so much
- Best estimates suggest that ~80-90% of tax costs/benefits go directly to (top bracket) owners
- Ok, but what about the 10-20% of tax costs/benefits passed on to workers?
 - [All recent research suggests](#) only the highest 30% of earners receive the costs/benefits of business tax changes.
 - No costs or benefits to the vast majority of workers
- Note: Changes in the top tax rates don't affect vast majority of small business owners, but still tax the vast majority of the income

Special Provisions

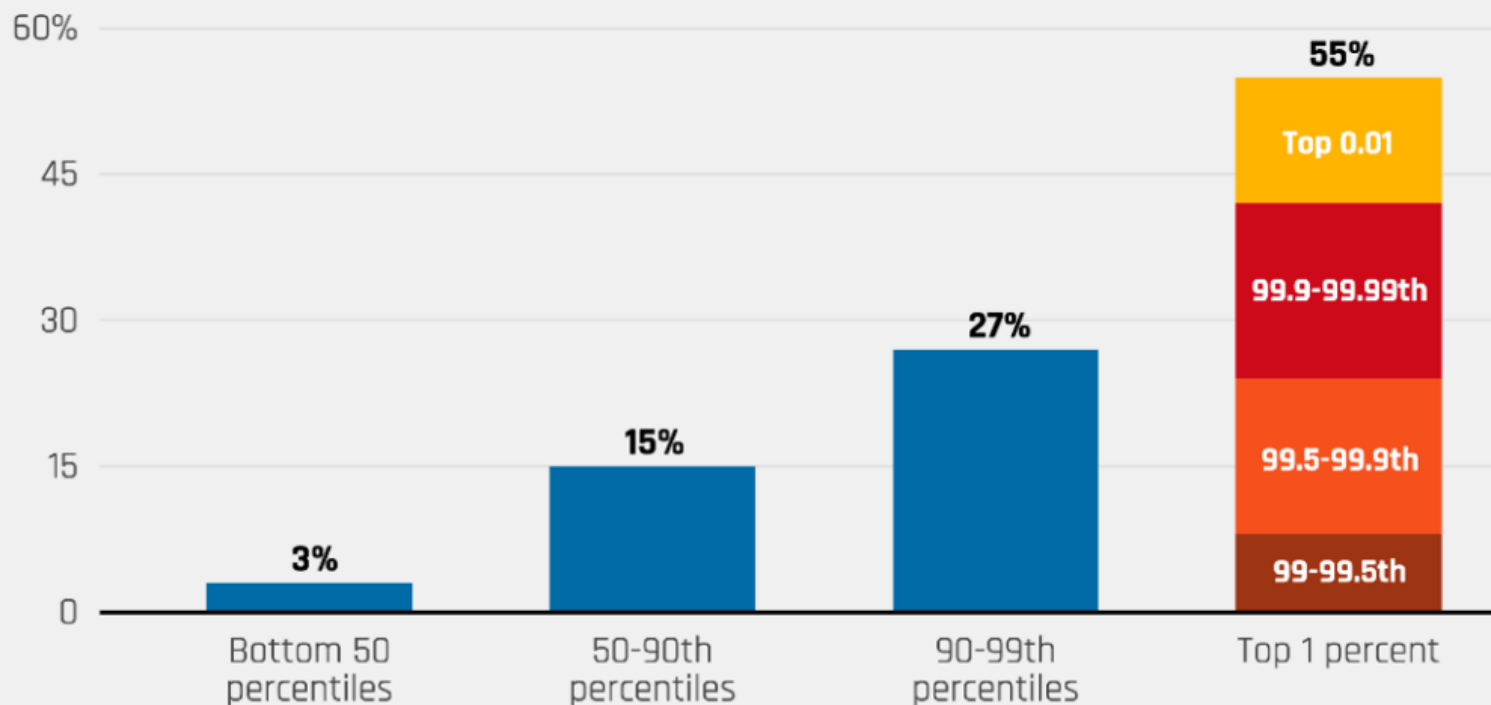
- **Section 199A**
- Payroll Taxes
- Carried Interest

Section 199A

- No positive economic effects
 - No increase in business investment, jobs, wages, or output
 - More evidence that trickle down doesn't work
 - Instead, only behavior change we see is wasteful tax planning, exploiting complexity
- Rewards wealthy owners of already very profitable, large companies
- Not needed for parity with C corporations

Trump tax bill's pass-through deduction overwhelmingly benefits the top 1% of U.S. income earners

Distribution of benefits from Section 199A, by income percentile, 2019



Source: Joint Committee on Taxation, "Present Law and Background on the Income Taxation of High Income and High Wealth Taxpayers" [2023], available at <https://www.jct.gov/getattachment/b2168cb1-1026-4e58-9f62-65802dddfa79/x-51-23.pdf>.

Note: Income measure is pre-tax, after-transfer. The JCT paper does not provide income cut-offs, but CBO, which use a comparable but not identical income measure, reports that a one-person household in the top 1 percent in 2019 earned more than \$451,700 [\$638,900 for a two-person household], and a one-person household in the top 10 percent in 2019 earned more than \$143,100 [\$202,400 for a two-person household]. See Table 2, Columns I and K, Rows 49 and 91 at <https://www.cbo.gov/system/files/2023-11/59509-supplemental-data.xlsx>.

Trump Tax Overhaul Showered Millions on Handful of Americans

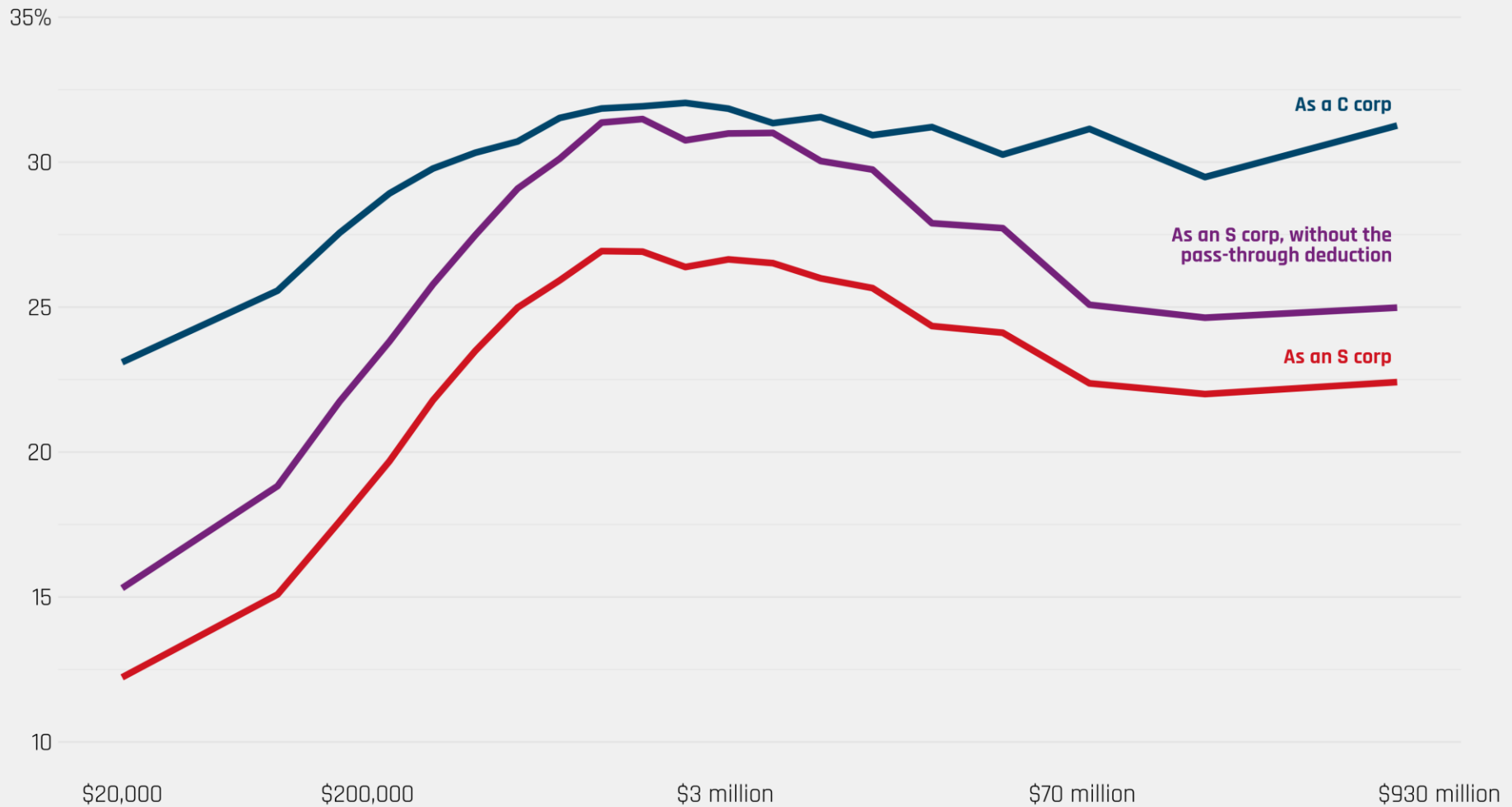
A select group of ultrawealthy pass-through business owners won huge deductions from the new law, reducing their taxable income and saving them millions in 2018, the first year of the tax break.

Name	Company	Deduction Claimed in 2018	Total Tax Savings in 2018
Michael Bloomberg	Bloomberg	\$183,425,118	\$67,867,294
Dick and Liz Uihlein	Uline	\$117,661,832	\$43,534,878
Diane Hendricks	ABC Supply Co.	\$97,055,543	\$35,910,551
Brendan Bechtel	Bechtel	\$64,248,567	\$23,771,970
Randa Duncan Williams	Enterprise Products Partners	\$38,738,334	\$14,333,184
Donald Bren	Irvine Company	\$22,055,742	\$8,160,625
Steven Roth	Vornado	\$12,223,390	\$4,522,654

Source: Justin Elliott and Robert Faturechi, “Secret IRS Files Reveal How Much the Ultrawealthy Gained by Shaping Trump’s ‘Big, Beautiful Tax Cut’” *ProPublica* (2021), available at <https://www.propublica.org/article/secret-irs-files-reveal-how-much-the-ultrawealthy-gained-by-shaping-trumps-big-beautiful-tax-cut>.

At all income levels, S corporations get a tax benefit from being S corporations

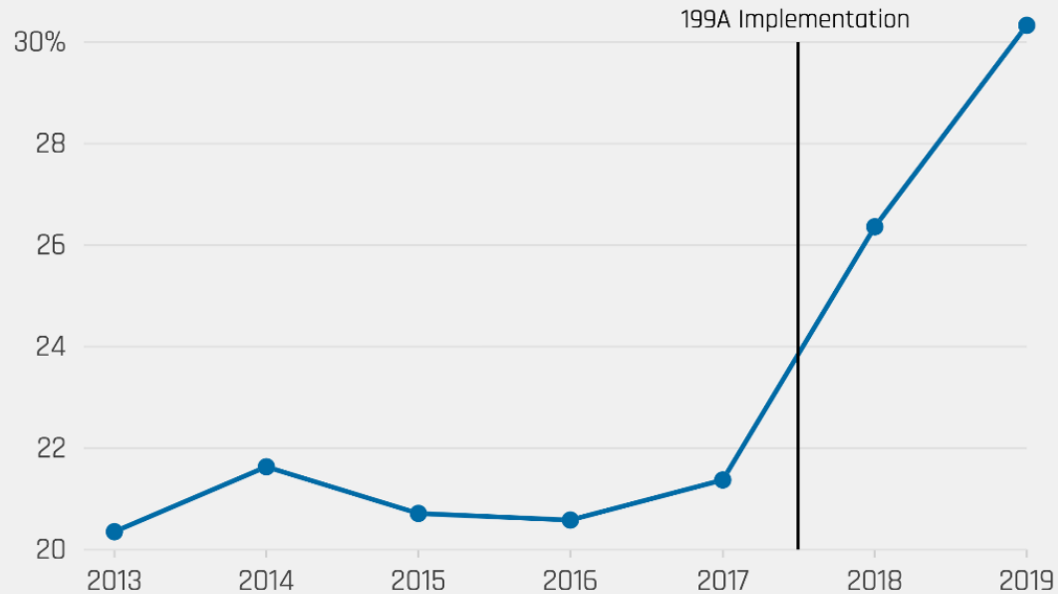
Average federal income tax rates, by total firm income



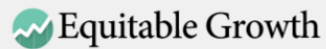
Source: Lucas Goodman, Quinton White, and Andrew Whitten, "Taxing S Corporations as C Corporations" (U.S. Department of the Treasury, 2024).

U.S. partners artificially reduced their salaries in order to maximize their pass-through deduction

Share of individual partners stopping their guaranteed payments, before and after the creation of Section 199A

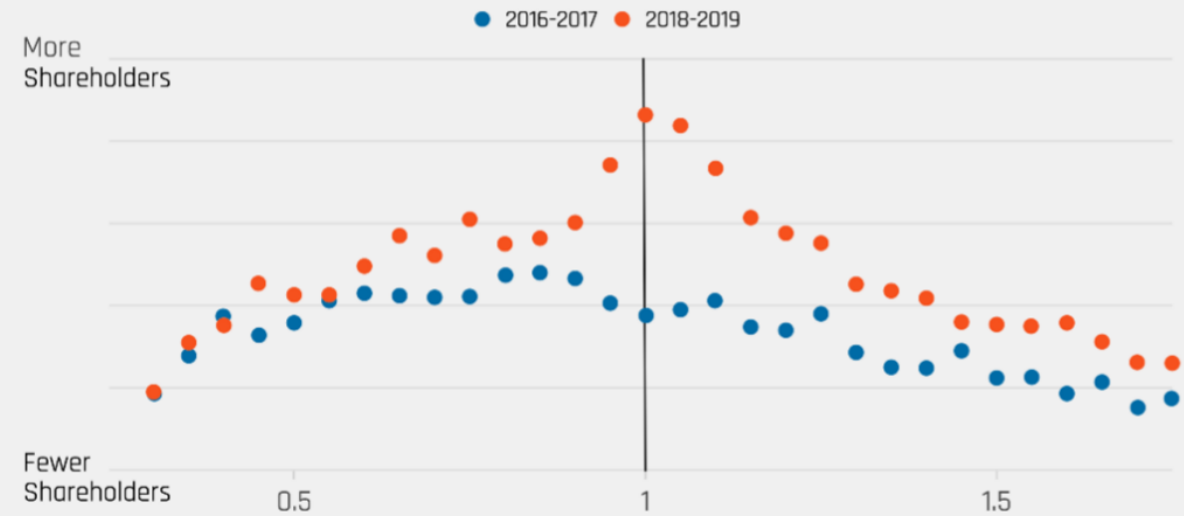


Source: Lucas Goodman, Katherine Lim, Bruce Sacerdote, and Andrew Whitten, "How Do Business Owners Respond to a Tax Cut? Examining the 199A Deduction for Pass-through Firms" Working Paper 28680 [National Bureau of Economic Research, 2021].

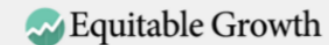


Shareholders of U.S. S-corporations artificially modified their wages to maximize their qualified business income deduction

Density of S-corporation shareholder wages as a function of the QBI maximizing level, before and after the creation of Section 199A



Source: Lucas Goodman, Katherine Lim, Bruce Sacerdote, and Andrew Whitten, "How Do Business Owners Respond to a Tax Cut? Examining the 199A Deduction for Pass-through Firms" Working Paper 28680 [National Bureau of Economic Research, 2021].



Allow 199A to expire

- Extending would cost \$684 billion/10
 - According to Treasury, even just phasing out the deduction for those making above \$400,000 would save \$673 billion/10 years, as compared to a full extension
- Other ways to target tax breaks to actual mom-and-pop small businesses

Special Provisions

- Section 199A
- **Payroll Taxes**
- Carried Interest

Payroll taxes

- Principle:
 - **Self-employment/payroll taxes** on labor income to pay for Medicare (2.9%) and Social Security (12.4% up to \$168,600)
 - Additional Medicare tax (0.9%) on labor income of high-income workers (>\$200,000/\$250,000)
 - **Net investment income tax** (3.8%) on capital income of high-income investors to pay for Medicare (>\$200,000/\$250,000)
- Loopholes:
 - Some S corp owners mischaracterize labor income as capital income to avoid SE tax (“reasonable compensation” standard hard to enforce)
 - Some active managers of partnerships claim “limited partner” status to avoid SE tax
 - Some S corp owners and partners claim “material participation” in business to avoid NII tax
- Fix: Ensure all pass-through income is covered by either NII or SE (\$420b/10)

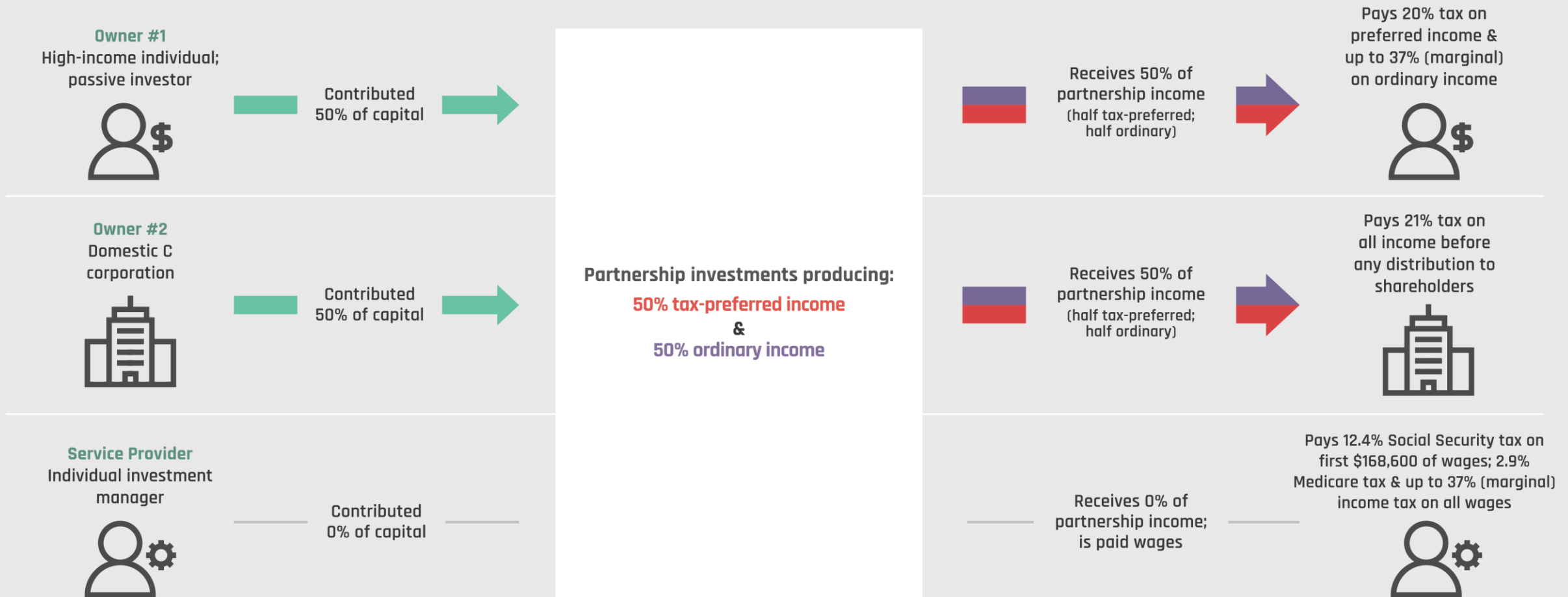
Special Provisions

- Section 199A
- Payroll Taxes
- **Carried Interest**

Lax U.S. partnership tax rules allow ownership structures that maximize tax avoidance

Capital contributions Tax-preferred income Ordinary income

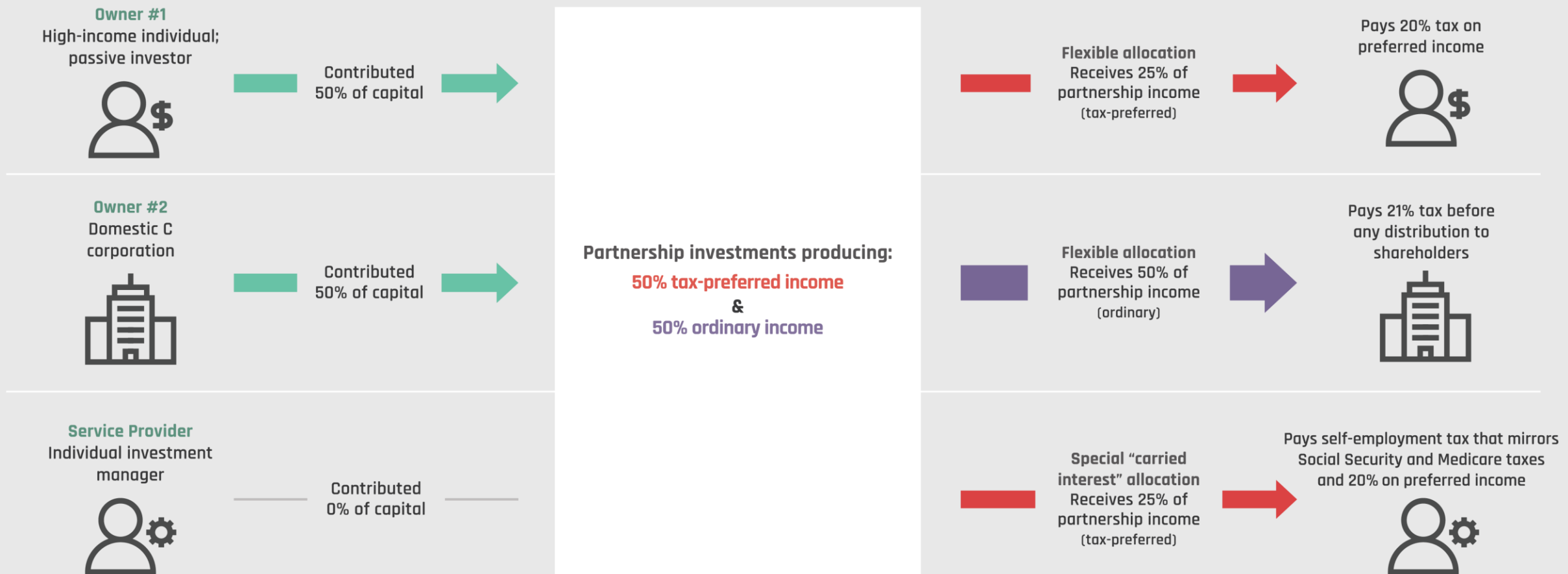
INFLEXIBLE ALLOCATIONS



Lax U.S. partnership tax rules allow ownership structures that maximize tax avoidance

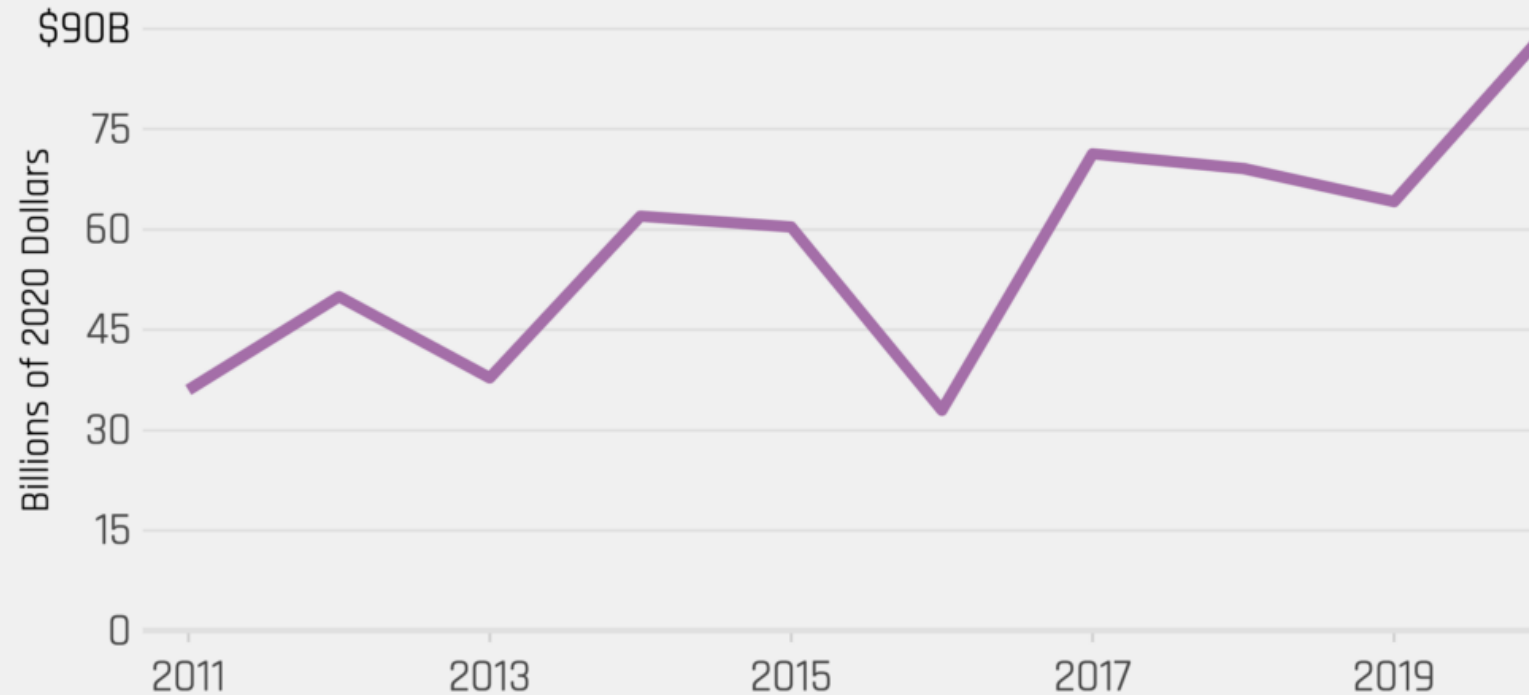
Capital contributions Tax-preferred income Ordinary income

FLEXIBLE ALLOCATIONS WITH A CARRIED INTEREST



Use of carried interest to compensate partners for services has been increasing

Carried interest allocations among U.S. partnerships, in billions of 2020 dollars, 2011-2020

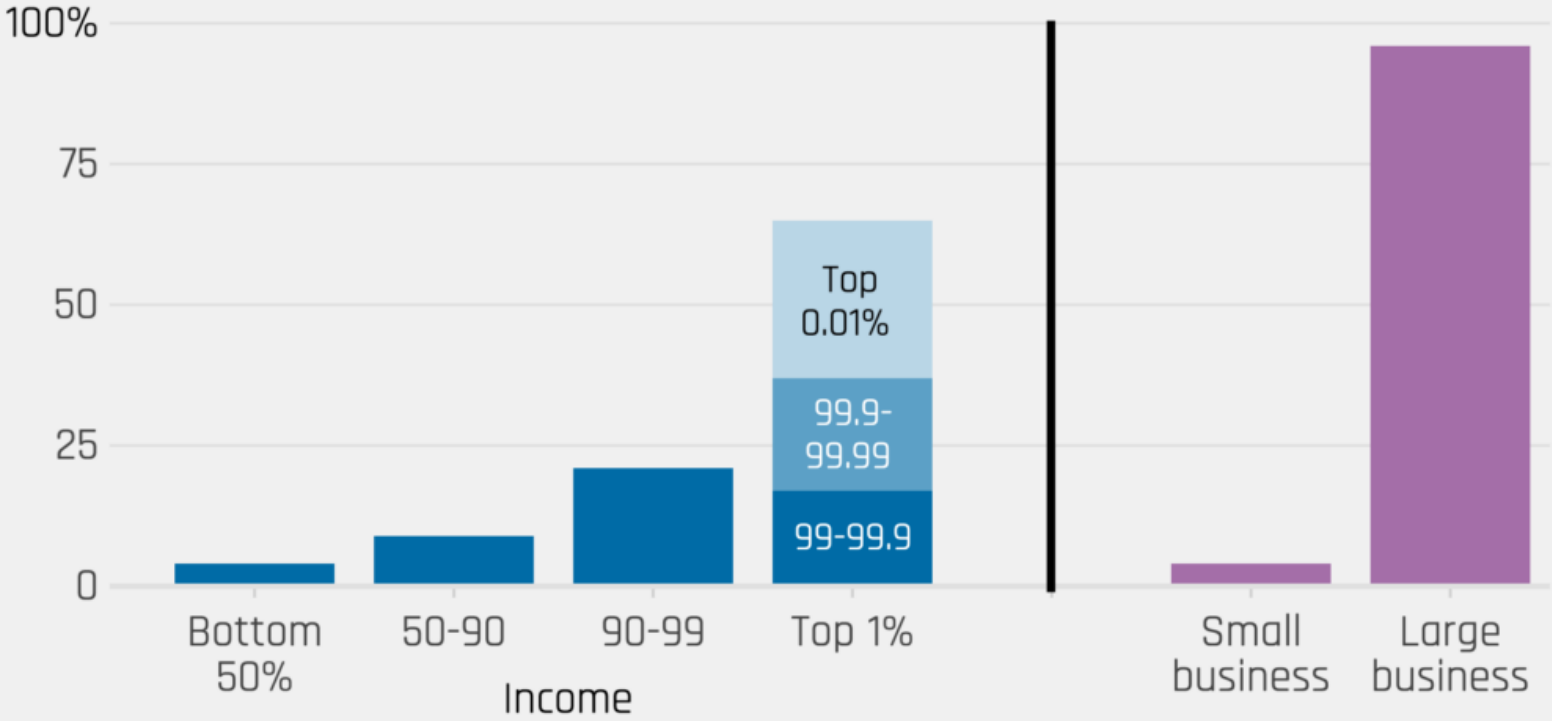


Note: This is Love's "preferred estimate" of carried interest, which falls between his lower-bound and upper-bound estimates and addresses concerns with each. See Appendix B of Love [2024].

Source: Michael Love, "Who Benefits from Partnership Flexibility?" Working Paper [2024], available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5014267.

Lax tax rules overwhelmingly benefit large, complex U.S. partnerships and their very wealthy partners, not true small businesses

Share of flexible allocations used by partnerships to reduce tax burden, by partner income and business type, 2011-2020

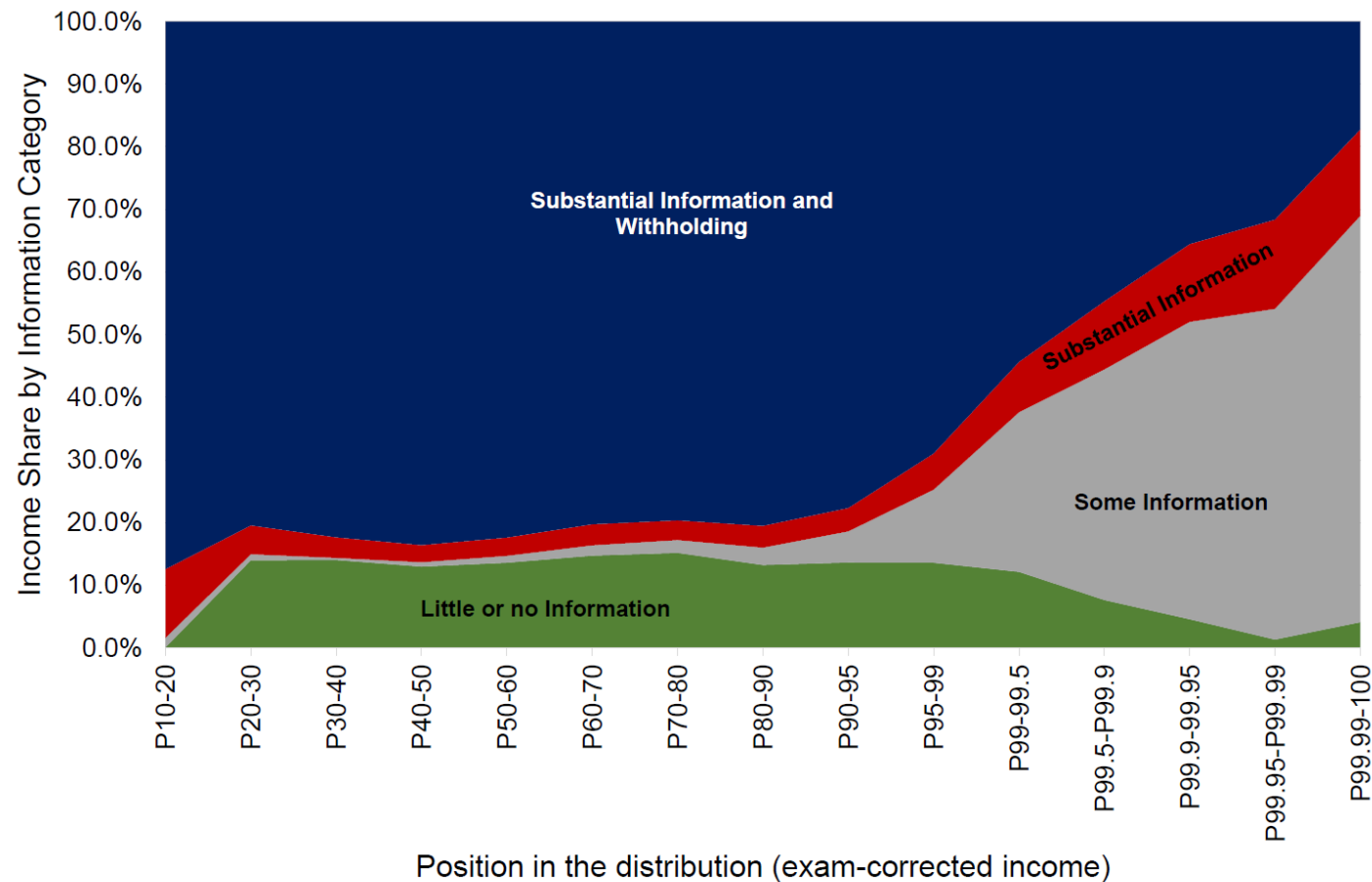


Source: Michael Love, "Who Benefits from Partnership Flexibility?" Working Paper [2024], available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5014267

Complexity & Enforcement

Partnerships and personal income tax compliance

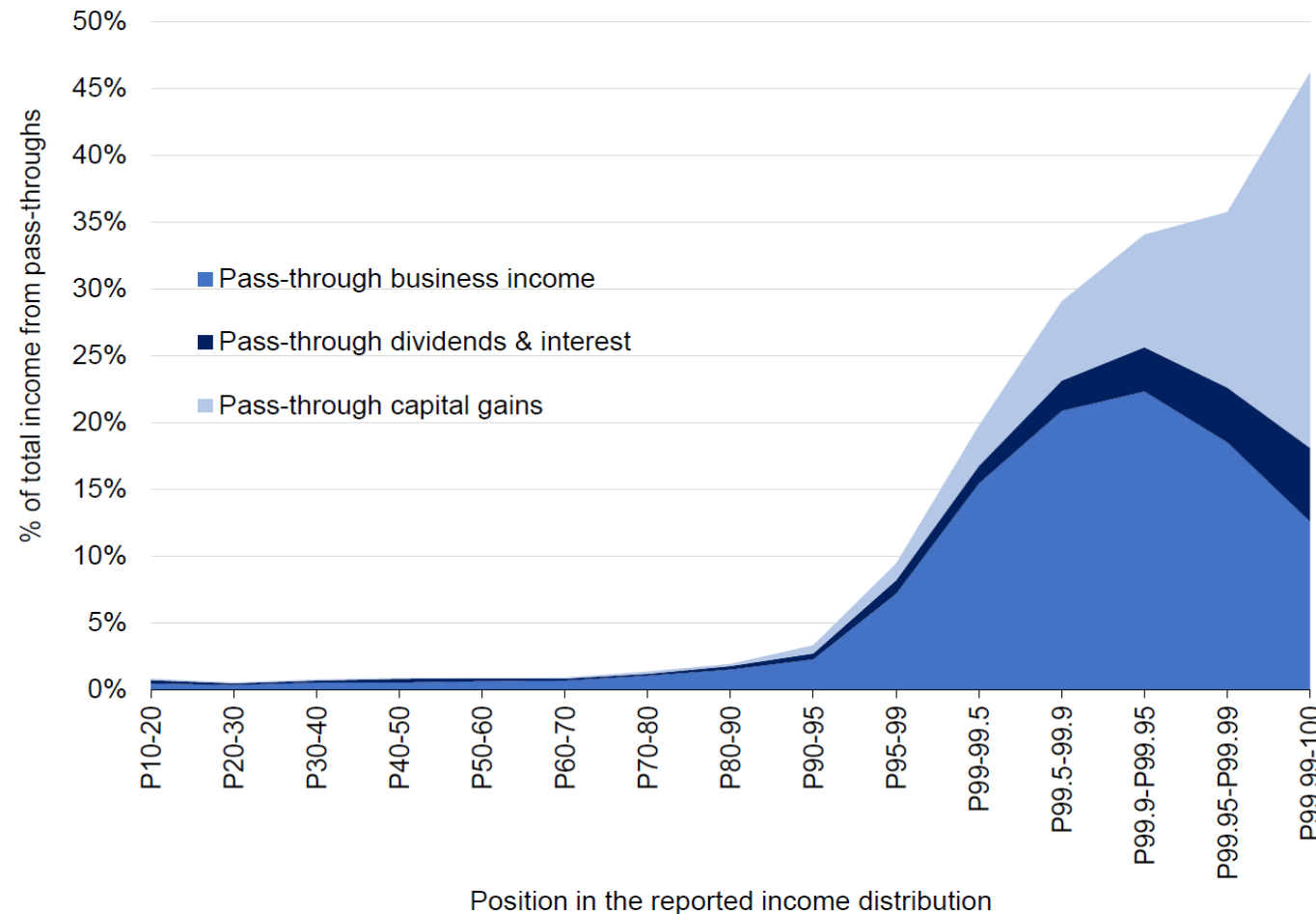
- 3rd party information reporting is fundamental to modern tax administration - falls off at top of income distribution, largely due to pass-through business income



Source: John Guyton and others, “Tax Evasion at the Top of the Income Distribution: Theory and Evidence” Working Paper 28542 (National Bureau of Economic Research, 2023), available at <https://www.nber.org/papers/w28542>.

Partnerships and personal income tax compliance

- Pass-through income highly concentrated at the top of the income distribution

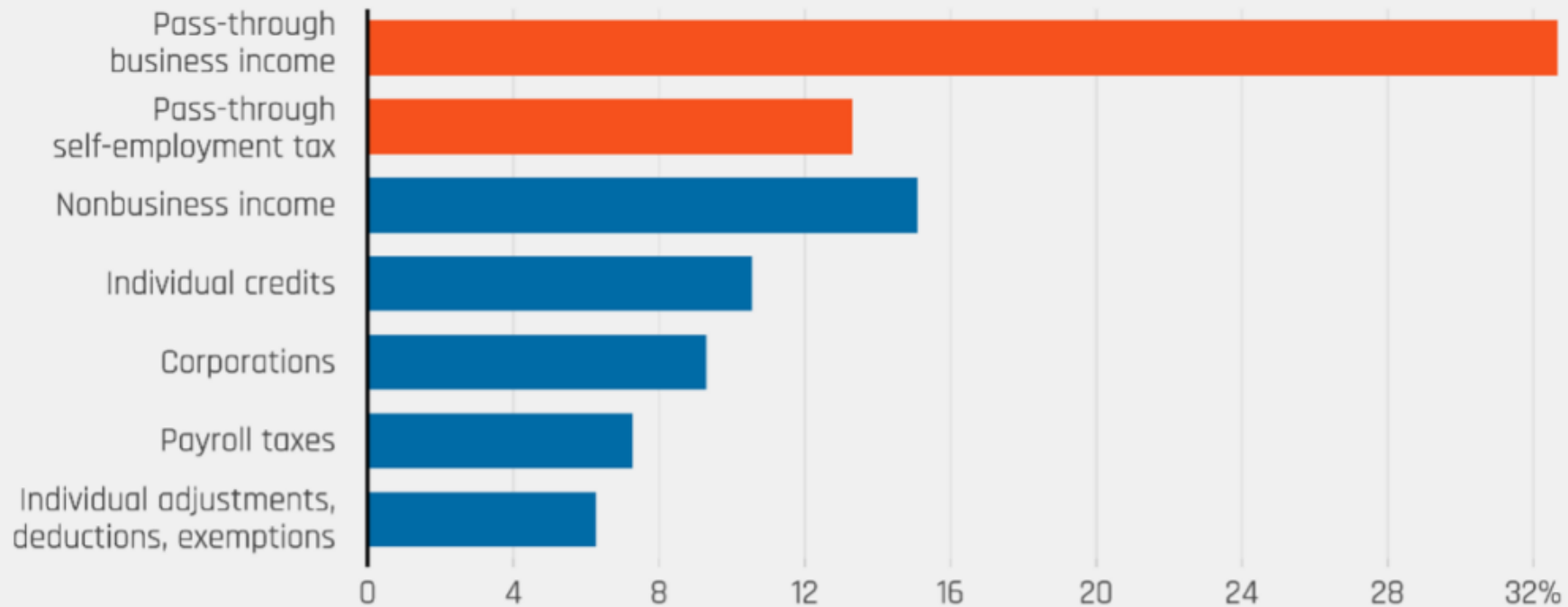


Source: John Guyton and others, “Tax Evasion at the Top of the Income Distribution: Theory and Evidence” Working Paper 28542 (National Bureau of Economic Research, 2023), available at <https://www.nber.org/papers/w28542>.

Tax gap largely attributable to pass-throughs

Underreporting of pass-through income is the major driver of the U.S. tax gap

Share of annual gross tax gap caused by underreporting of income, by income source, 2014-2016

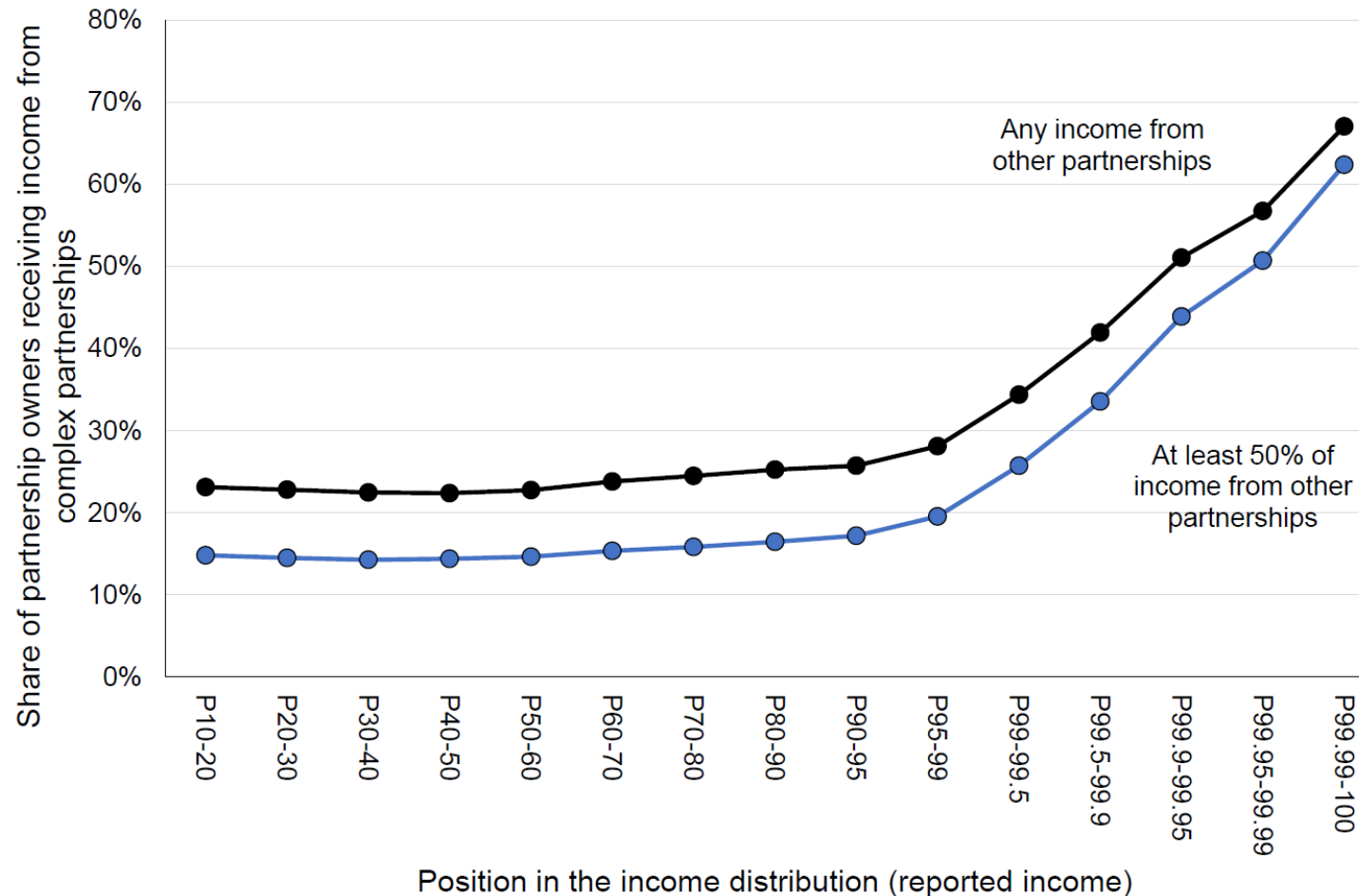


Source: Internal Revenue Service, "Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2014-2016" [2022], available at <https://www.irs.gov/pub/irs-pdf/p1415.pdf>; Samantha Jacoby, "Policymakers Should Ensure Pass-Throughs Pay More of Taxes They Owe" [Center on Budget and Policy Priorities, 2019], available at <https://www.cbpp.org/blog/policymakers-should-ensure-pass-throughs-pay-more-of-taxes-they-owe>.

Note: Payroll taxes includes Federal Insurance Contributions Act [FICA] and Federal Unemployment Tax Act [FUTA].

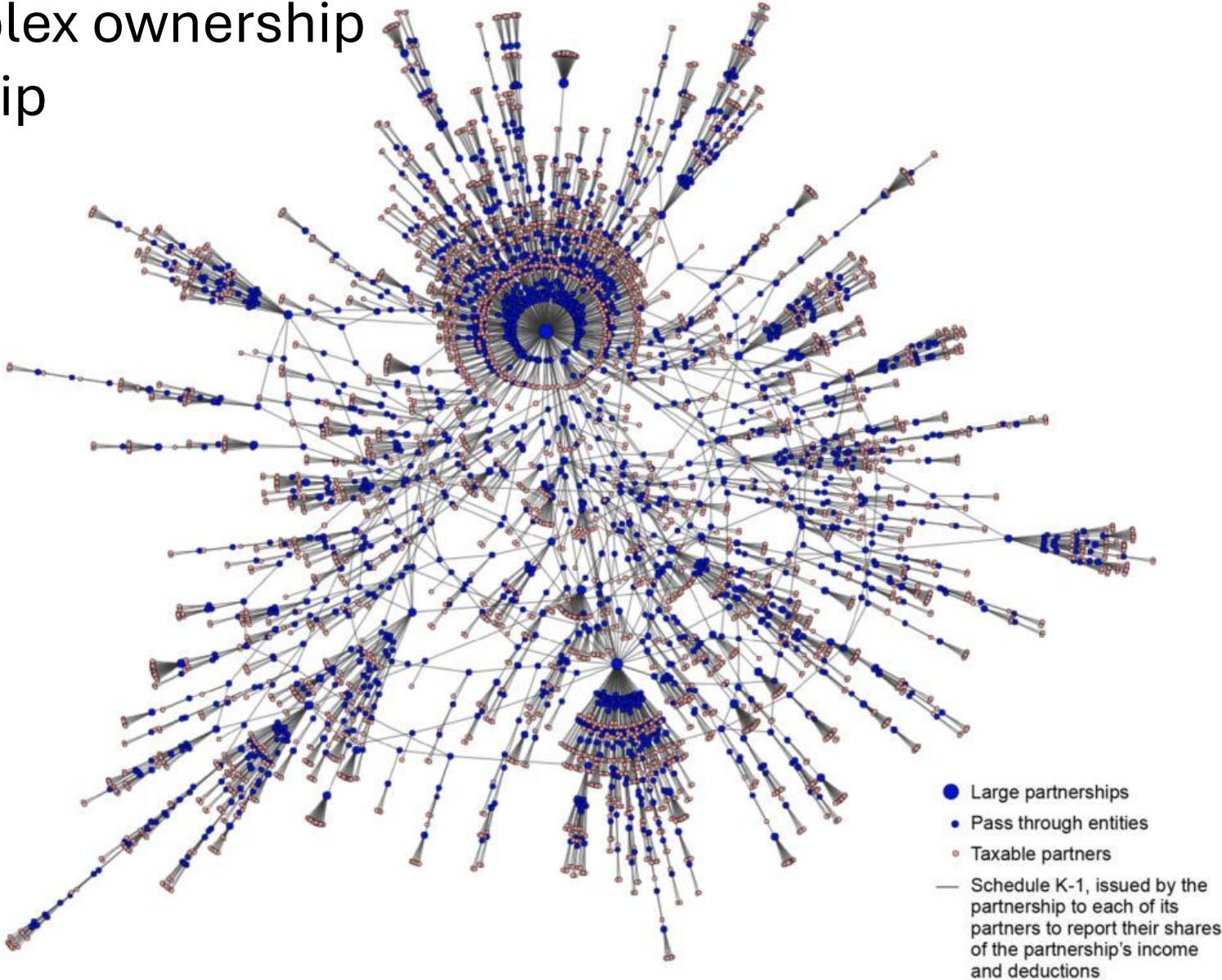
Partnerships and personal income tax compliance

- **Partnership complexity** also increases across the distribution (measured as partnerships that are owned by chains of partnerships)



Source: John Guyton and others, “Tax Evasion at the Top of the Income Distribution: Theory and Evidence” Working Paper 28542 (National Bureau of Economic Research, 2023), available at <https://www.nber.org/papers/w28542>.

Illustrative example of a complex ownership structure for a large partnership in the United States

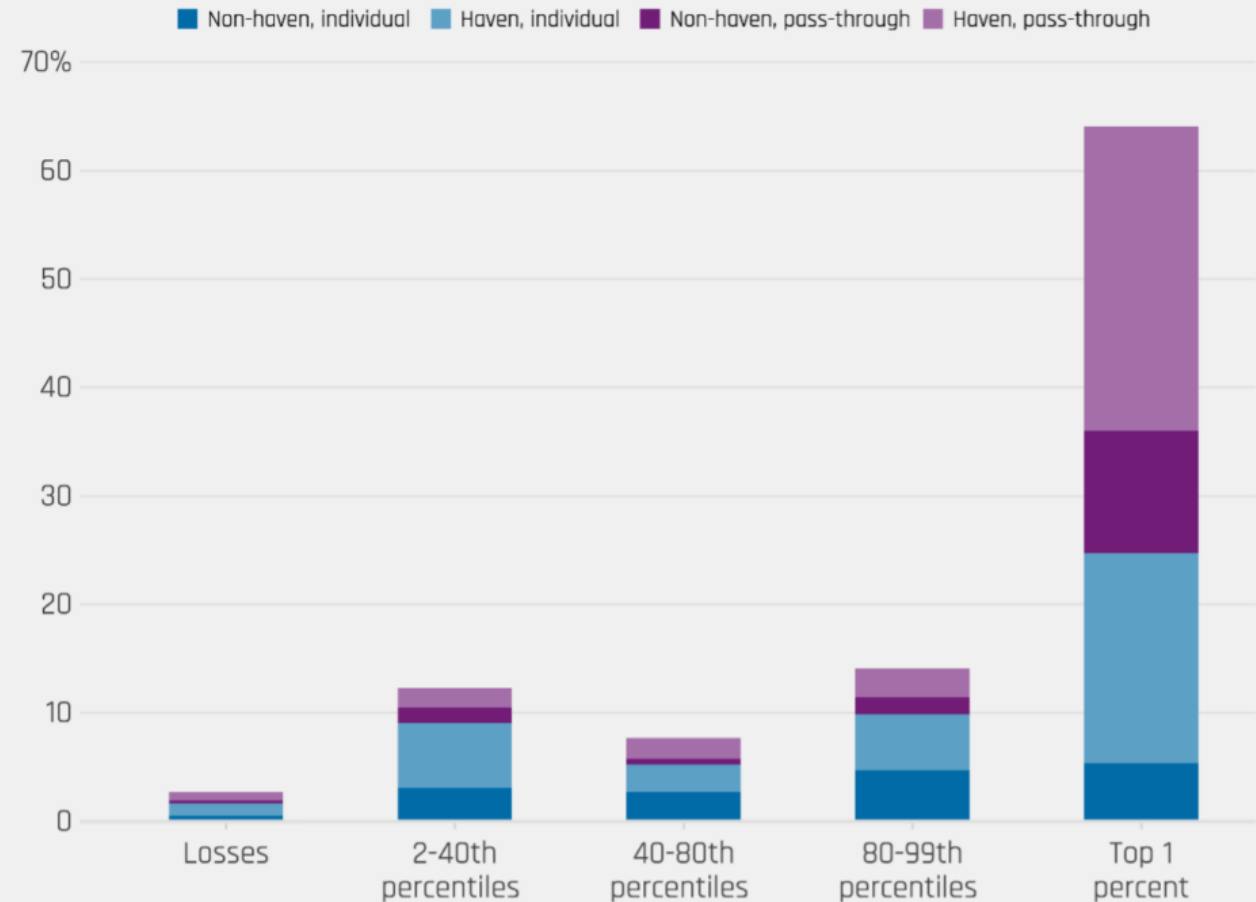


Source: U.S. Government Accountability Office, “Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships” (2023), available at <https://www.gao.gov/assets/gao-23-106020.pdf>.

Majority of U.S. assets held in tax havens are owned through pass-throughs

Pass-throughs are the preferred vehicle through which the top 1 percent hold wealth in tax havens

Distribution of total foreign assets held directly and through U.S. pass-through entities, in tax havens and non-tax-havens, by position in the income distribution, 2018

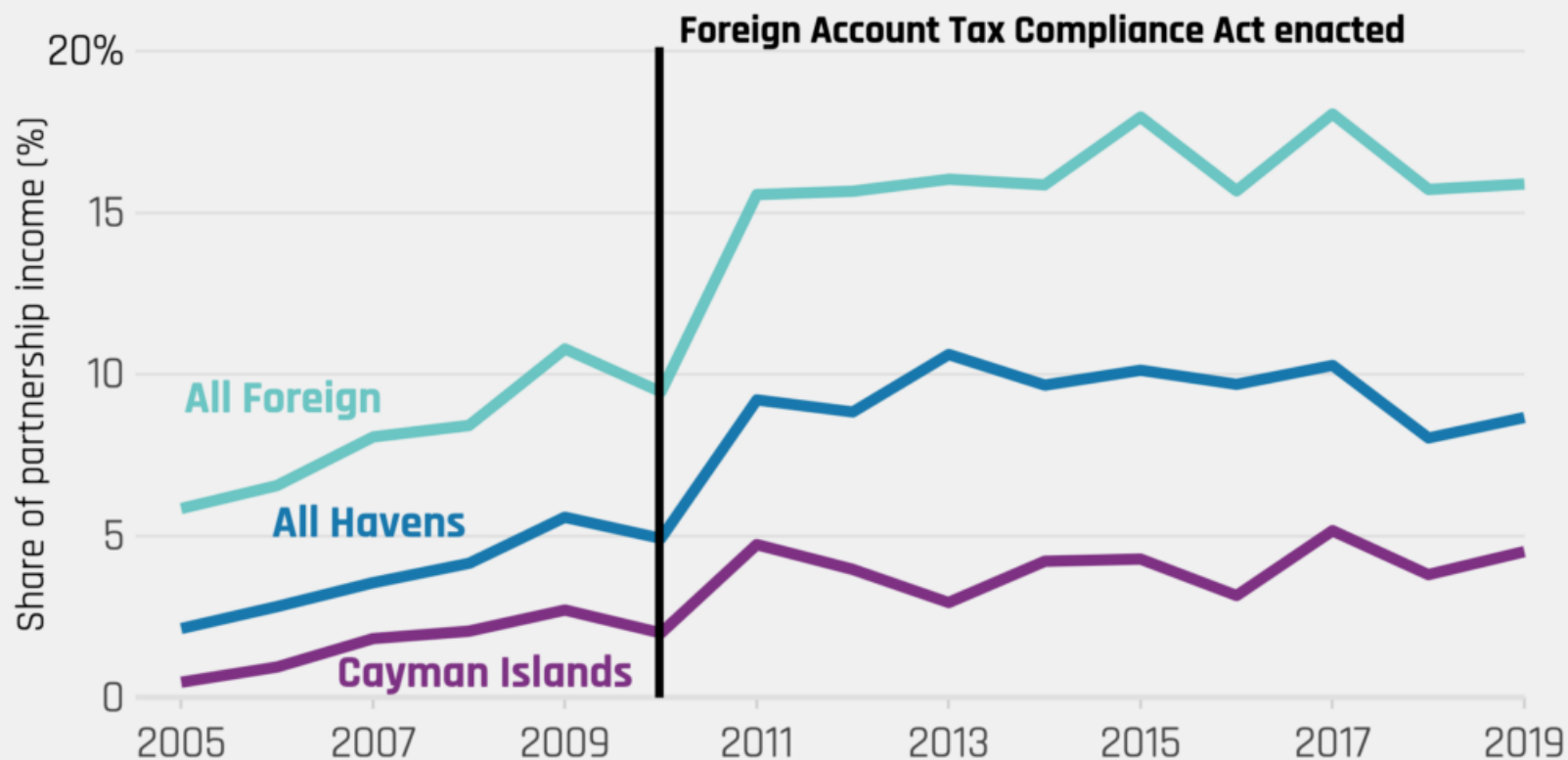


Source: Niels Johannesen and others, "The Offshore World According to FATCA: New Evidence on the Foreign Wealth of U.S. Households" (2023), available at <https://www.irs.gov/pub/irs-soi/23rpfatcaevidenceforeignwealth.pdf>.

Note: The paper does not include specific dollar cut-offs, but prior research by Emanuel Saez, which uses a comparable but not identical definition of income, finds that the top 1 percent in 2018 included those who earned more than \$567,268. See Table A6, Column R at <https://eml.berkeley.edu/~saez/TabFig2022.xlsx>.

Partnerships are a growing source of income for foreigners in tax havens

Share of U.S. partnership income flowing to foreign owners, 2005-2019

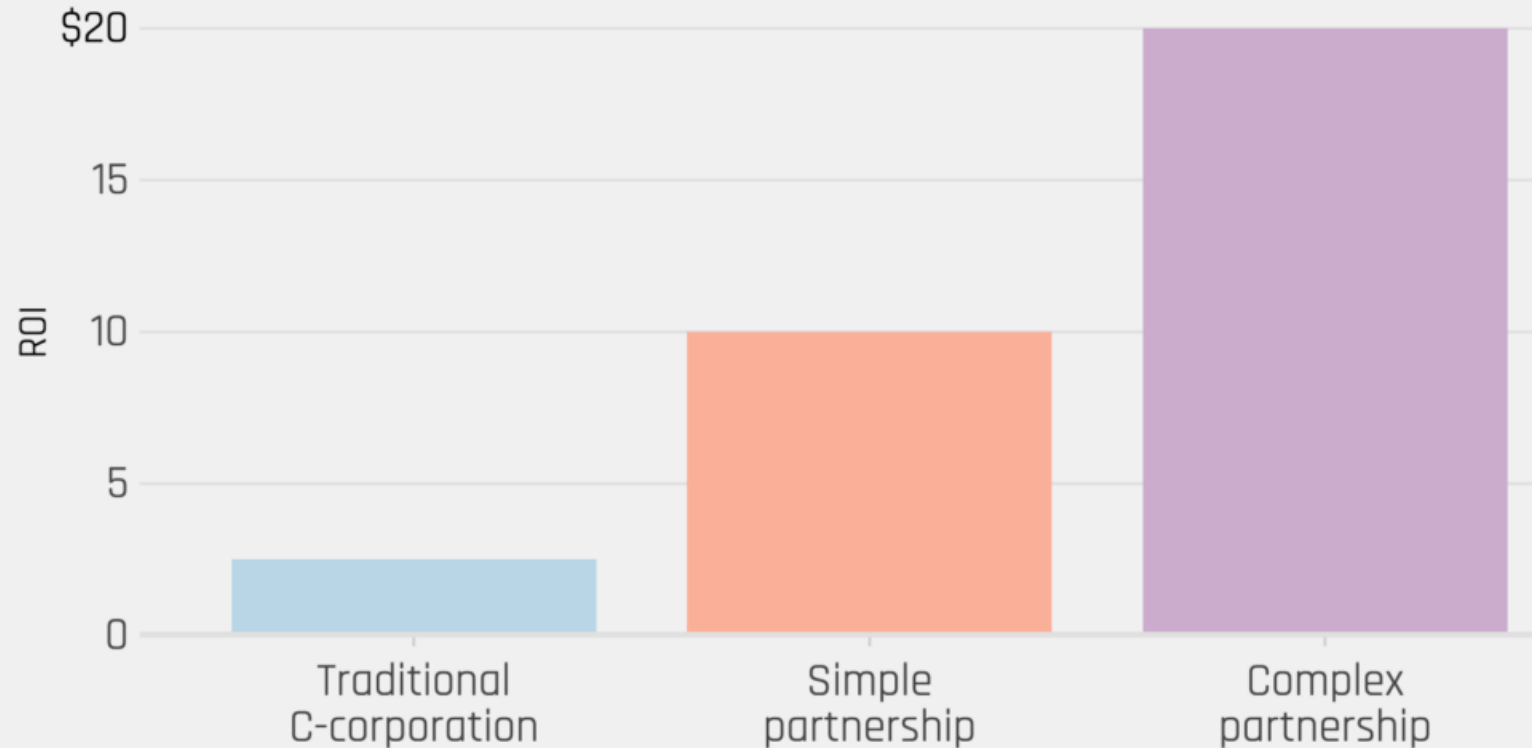


Note: "All Havens" includes Cayman Islands, zero-rate havens, other havens, and conduit countries as defined in Table 1 of Love [2021].

Source: Michael Love, "Where in the World Does Partnership Income Go? Evidence of a Growing Use of Tax Havens." Working Paper [2021], available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3985535.

Auditing complex U.S. partnerships produces a huge return on public investment

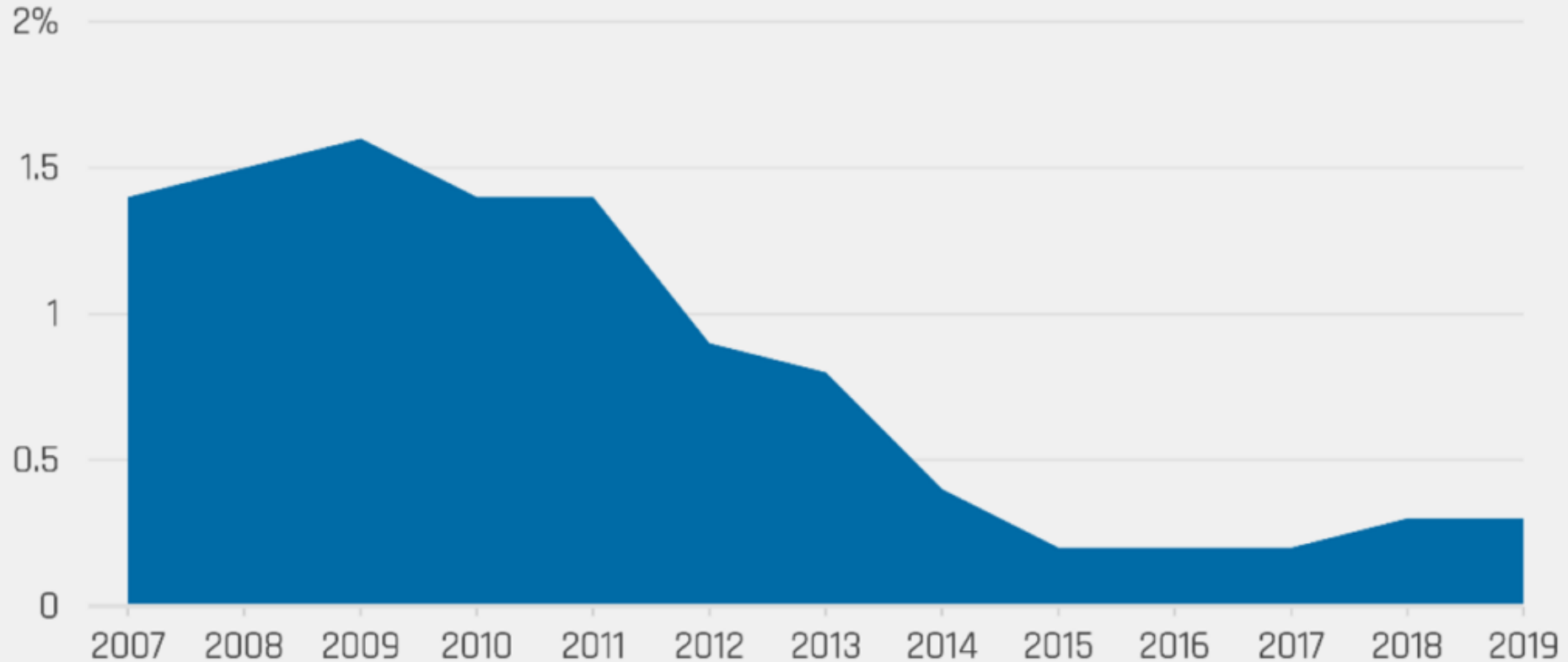
Federal government revenue collected for every \$1 spent on IRS audits of different business types



Source: Michelle Nessa and others, "How do IRS resources affect the corporate audit process?" [2020], available at <https://doi.org/10.2308/accr-52520>; Ryan Hess and others, "The Spiderweb of Partnership Tax Structures." Working Paper [Washington Center for Equitable Growth, 2025], available at <https://equitablegrowth.org/working-papers/the-spiderweb-of-partnership-tax-structures/>.

Large partnerships mostly escape IRS scrutiny

IRS field audit rate for large partnerships in the United States, 2007-2019



Source: Government Accountability Office, "IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships" (2023), available at <https://www.gao.gov/assets/gao-23-106020.pdf>.

Note: "Field audits" are detailed examinations of the partnership's tax return and supporting records to determine whether income and losses are properly reported. "Large partnership" means more than \$100 million in assets and more than 100 partners.

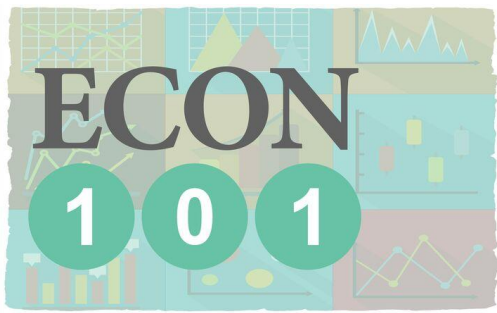
Policy Implications: Enhance enforcement

- Fully fund the IRS
 - Preserve the new Pass-Through Compliance Unit and Large Partnership Compliance Program
- Better reporting
 - Specify special allocations
 - Provide org charts
 - Identify beneficial owners
 - Note: Can do this progressively
- Other
 - Means-tested penalties / statutes of limitations
 - Complexity fee

Some takeaways

A large share of income at top of the distribution is flowing through pass-throughs (particularly complex partnerships):

- Understanding incentives to hold money through these structures, including the tax, legal, and efficiency costs/benefits are critical to conceptualizing and measuring income inequality in the U.S.
- Regulation and tax (enforcement) policy aimed at pass-throughs will disproportionately affect the top of the distribution
 - Implications for revenue, tax fairness, equity and efficiency trade-off
- Tax enforcement: Audit rates are likely important, but type of audits, resources, and technology available to revenue services to understand complex partnership structures, asset holding and income flows are likely just as important



Questions?



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Equitable Growth Resources

- [Factsheet: What the research says about taxing pass-through businesses](#)
- [Issue Brief: 2017 tax cut for pass-through business owners exacerbated inequality and failed to deliver economic benefits](#)
- [Report: Tax avoidance among large, complex partnerships in the United States](#)