The Art of the Pass-Through

By Ryan Erickson and Brendan V. Duke August 2016

A new report from the Center for American Progress finds that big businesses are masquerading as small businesses by organizing themselves as pass-through entities in order to avoid paying the corporate income tax.[1] The ability of the largest U.S. hedge funds and real estate companies to reduce their tax bills in this manner has cost the Federal Treasury hundreds of billions of dollars.

Unlike C corporations—which pay taxes at the entity level—pass-throughs are businesses that pay no taxes as an entity; instead, their income is passed on directly to the pass-through's owners, who pay taxes on it using their own income tax returns. A recent study by Michael Cooper and other economists at the U.S. Treasury Department, the University of California, Berkeley, and the University of Chicago show that not paying taxes on the entity level has led to income from pass-throughs being taxed at a much lower rate than income from C corporations.[2]

Some politicians have tried to justify further tax cuts for pass-throughs by calling them small businesses, but—as the CAP analysis shows—those tax cuts would heavily benefit big business.[3] Indeed, 70 percent of revenue from partnerships and S corporations—the two fastest growing types of pass-throughs—goes to big businesses, which are defined as firms with more than $10 million in annual revenue.[4] And those tax savings would heavily benefit the financial industry and the top 1 percent of households.[5]

A prime example of the ability of businesses to avoid the corporate income tax is the Trump Organization LLC, a holding company for the various business ventures and investments of Donald Trump, who is the LLC's chairman and president, as well as the presumptive Republican presidential nominee.[6] In fact, Trump boasts that he "uses everything in the book to avoid taxes"—advice he also imparts in a textbook, used at the now defunct Trump University, that details how real estate developers can use pass-throughs to reduce their tax bills.[7]

As part of his presidential platform, Trump has offered a tax plan that would reduce the tax rate on pass-through entities, such as his own Trump Organization LLC, to 15 percent.[8]

But the plan fails to acknowledge that cutting taxes on all pass-throughs, even big ones, would come at a steep cost: the loss of billions of dollars in sorely needed tax revenue and the exacerbation of income inequality. In fact the rise of these pass-through entities, such as partnerships and S corporations, already deprived nearly $800 billion from the Federal Treasury between 2003 and 2012—depleting resources that could have been spent repairing schools, cutting taxes for everyday Americans, or reducing the national debt.[9]

Trump's pass-through tax cut would further enrich his companies, other big businesses, and the financial and real estate industries. Meanwhile, the programs and initiatives that Americans depend on—such as Social Security, Medicaid, and Medicare, infrastructure investment, and scientific research—would likely suffer from the lost tax revenue.

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Pass-throughs and the Trump tax plan

Discussions about big businesses tend to focus on C corporations, which are businesses that pay taxes on their profits.[10] But big businesses can also be organized as partnerships, S corporations, or sole proprietorships, which are called pass-throughs since all of their income is passed through to their individual owners, who pay taxes on their individual income tax returns and thus avoid the corporate income tax altogether.[11]

Today, a majority of business income goes to pass-throughs and therefore is not taxed at the corporate level.[12] The most important reason why pass-throughs are now the dominant business form is to avoid paying the corporate tax, dramatically reducing a business's tax rate. In 2011, the effective tax rate on pass-through income—the share of income pass-through businesses actually pay in tax—was a low 19 percent compared to 32 percent for C corporation income, when combining the corporate income tax and individual taxes on dividends.[13]

The low effective tax rate on pass-throughs in 2011 came despite a much higher top statutory tax rate of 35 percent on individual income.[14] Pass-throughs—especially partnerships—not only avoid the corporate income tax, but they also use a variety of accounting tricks to reduce their effective tax rate to 19 percent. While the top statutory tax rate on pass-through income is now 39.6 percent, pass-through businesses certainly continue to pay a much lower effective rate.[15]

Trump's tax plan doubles down on pass-throughs as a tax avoidance strategy by creating a new, very low top tax rate for pass-through income of 15 percent—tying it to his proposed corporate tax rate of 15 percent and pegging it below his top rates for individual income and capital gains taxes of 33 percent and 20 percent, respectively.[16] The reason that Trump offers for his low pass-through rate is that his proposed 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."[17]

But as the CAP analysis makes clear: Big business, the financial and real estate industries, and the top 1 percent of households are the biggest winners with Trump's proposed lower rate on pass-through income. And the small businesses that Trump purports to help, would not benefit nearly as much.

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Who benefits from Trump's pass-through plan?

CAP's analysis breaks down three areas where Trump's plan for a lower rate for pass-through entities would benefit three groups that are in no need of help: big business, the financial and real estate industries, and the top 1 percent of households.

Big business

Trump's plan to lower the tax rate on pass-through income amounts to doubling down on a tax trick that helps big businesses skirt their taxes. The vast majority of small businesses are pass-throughs but the lion's share of a pass-through tax cut's benefits would end up going to big businesses.[18] Like Trump, those who defend lower tax rates for pass-throughs—including partnerships and S corporations— suggest that all pass-throughs are small businesses and all small businesses are pass-throughs.[19] But both statements are false.

CAP's analysis shows that, contrary to the perception that all pass-throughs are small businesses, a full 70 percent of the receipts from partnerships and S corporations go to big businesses, which the analysis defines as businesses with $10 million or more in annual receipts.[20] The vast majority of partnerships and S corporations—99 percent and 98 percent, respectively—are indeed small.[21] However, the tiny sliver of less than 3 percent of partnership and S corporations that are big businesses make nearly three-quarters of the revenue going to all partnerships and S corporations.[22] Given that reality, slashing the tax rate on pass-through income is a huge gift to these big businesses.

Wall Street and the real estate industry

A lower pass-through rate would also have an outsized and beneficial impact on the financial and real estate industry sector. Cooper and his coauthors show that, in 2011, 70 percent of the income from partnerships went to the financial industry—including banks, hedge funds, and private equity firms—the real estate industry, and holding companies.[23]

Ironically, Trump's low pass-through rate for Wall Street firms would render another one of his supposedly populist tax stances meaningless: Trump's proposal to close the carried interest loophole and reclassify income from carried interest as ordinary income.[24]

Because entities that earn carried interest income are organized as partnerships, these organizations would pay the lower 15 percent pass-through rate on their income.[25] In other words, Trump's tax plan would actually create an even lower tax rate for the very people he is claiming to target by "reducing or eliminating deductions and loopholes available to the very rich."[26]

The top 1 percent of households

Finally, lowering the rate on pass-throughs would give an especially huge gift to the top 1 percent of households. Again, according to the recent study, "Given that the financial industry and holding company sectors receive the majority of partnership income, it is not surprising that 70 percent of partnership income goes to the top 1 percent of households, while just 13 percent goes to the bottom 90 percent of households. These numbers are practically identical for S corporations."[27] Broken down by pass-through type, 69 percent of the income from partnerships and 67 percent of the income from S corporations goes to the top 1 percent of households.

Far from helping small businesses or eliminating tax advantages available only to the very rich, Trump's tax plan would increase the after-tax incomes of the wealthy. CAP's analysis shows that the rise of partnerships and S corporations helped drive the growth of income inequality. In particular, the analysis concludes that about 40 percent of the increase in the share of market income going to the top 1 percent is explained by pass-through income between 1979 and 2011, similar to what Cooper and his coauthors found.[28] While pass-through income accounted for just 6.8 percent of market income growth for middle-class families between 1979 and 2011, it accounted for 31.3 percent of income growth for the top one percent of families over the same period.[29]

Just another tax con

Trump may claim that his lower rate for pass-throughs is a move to shore up small businesses, but in reality, Trump's lower tax rate on partnerships and S corporations is effectively a gift to big business, the financial and real estate industries, and the top 1 percent of households. These groups stand to gain the most from Trump's proposed tax cut on pass-throughs.

As noted above, Trump's lower pass-through tax rate comes at a cost. As CAP's analysis points out, a growing number of big businesses are choosing to organize as pass-through entities precisely because doing so effectively lowers their tax bills. The analysis shows that the growth of these lightly taxed pass-throughs dented federal revenues by $790 billion between 2003 and 2012, money that could have been spent on infrastructure, education, or medical research.[30] Lowering the tax-rates on pass-through income, as Trump proposes, will only make this problem worse—sapping sorely needed tax revenues while guaranteeing even bigger returns for those at the top.

Unsurprisingly, Trump stands to be one of the biggest winners with a lower pass-through income tax rate. On Trump's 2015 financial disclosure form, he listed income from 68 limited liability companies, or LLCs, and other limited partnerships—two types of pass-throughs.[31] In fact, lawyers representing Trump noted in a letter that their client, Donald Trump, "is the sole or principal owner in approximately 500 separate entities" that he operates "almost exclusively through sole proprietorships and/or closely held partnerships."[32] These just happen to be the two types of pass-throughs with the lowest tax rates.[33]

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While Trump is never bashful about admitting that he employs every tax trick in the current tax code to ensure he pays as little tax as possible, his proposal to lower the tax rate on partnerships and other pass-throughs would stack the deck even more in his favor.[34] Donald Trump—a real estate tycoon who proudly boasts of his wealth and the value of his properties—is perhaps the ultimate example of someone who benefits from low tax rates on partnerships.

Moreover, the now-defunct Trump University—itself an LLC[35] —offered a Trump University-branded tax guide that extolled the benefits of LLCs and limited partnerships for helping wealthy real estate developers avoid taxes. The books are part of a series that Trump described in a foreword as teaching "the same concepts taught in the most respected MBA curriculums and used by the most successful companies in the world, including the Trump Organization." The book notes:

> *LLCs and LPs are perfect for real estate investors because of their tax benefits. First, these entities can help you save on your capital gains taxes. … Capital gains tax rates are lower for individuals than for corporations since corporations have their own tax obligation that must be met before the potential double taxation that could result once the income is passed on to its owners. What this means is that if you realize a capital gain on a property held in an LLC or LP, you will save money on taxes. More money means the ability to invest in more properties. …*
>
> *The pass-through taxation of LLCs and LPs can also be a tax benefit… because any losses sustained by the business would be a deduction on your personal tax return. …*
>
> *The most powerful tax benefit of LLCs and LPs that is particularly useful for real estate businesses stems from the fact that these two business entities have free transferability of assets. This means that money or other assets can be moved into or out of the business without such a contribution or distribution being a taxable event.*[36]

Conclusion

In short, Donald Trump's tax plan that features a special, low tax rate for pass-through business income is just another con. Lowering the tax rate on pass-throughs is tailored to suit big businesses grasping at new ways to avoid paying taxes, benefiting the financial industry and real estate firms dominated by the highest earners and people in the top 1 percent of households. Far from paying for his tax plan by "reducing or eliminating deductions and loopholes available to the very rich," Trump is proposing to expand a tax benefit that has drained tax revenue needed for key programs and investments for the country's future.[37]

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Endnotes

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