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How S-Corp and Other "Pass-Through" Income Is Taxed and the Effects of Proposed Tax Reforms

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Recent state and federal tax reform debates have highlighted the taxation of S-corporations (S-corps) and other "pass-through" entities. These are businesses that are not required to pay the corporate income tax. Instead, their owners pay personal income taxes on the profits of the corporation (the income is "passed through" to the owners for tax purposes). At the federal level, President Trump has proposed dramatically reducing the tax rate on this type of income.[1] In Massachusetts, owners of pass-through entities like S-corps have voiced concerns about the fact that a proposed four percent tax on incomes over one million dollars a year would include very high-income owners of pass-through businesses.[2] In recent years, there have also been debates over the taxation of S-corp and other pass-through income in other states. In 2012, Kansas passed a law eliminating all taxes on pass-through income with hopes that the tax break would spur economic growth. It did not have that effect. The Kansas bond rating has been reduced twice since the tax break was enacted.[3] This year the Republican-controlled legislature in Kansas repealed the tax break.[4]

This fact sheet explains what S-corps and related "pass-through" business structures are, describes how they are taxed, and examines how they would be affected by federal and state proposals.

What are S-Corps and Other Pass-Through Entities?

There are a number of ways that a business can be structured. The traditional corporate form is what is known as a C-corporation. There are two major differences between C-corps and S-corps: S-corps can have no more than 100 shareholders, and S-corps are not required to pay the corporate income tax. There is no limit, however, on the size of an S-corp in terms of total income or total assets.

There are several other common types of pass-through businesses: Limited Liability Companies (LLCs), Partnerships, and Sole Proprietorships. LLCs are similar to S-corps, but they are allowed more flexibility in management structures (they can be owned by other corporations, for example).[5] Partnerships (except limited liability partnerships) and sole proprietorships do not provide one of the major benefits of other business forms: limited liability. When corporate forms provide limited liability, the owners can only lose the amount they invest in the company. Without limited liability, if a business can't pay its debts, the creditors can then collect from the owners of the business.

How are S-Corps and Other Pass-Through Entities Taxed on Income?

Regular corporations (C-corps) are subject to federal and state corporate income taxes (sizeable businesses pay about 35 percent at the federal level and 8 percent in Massachusetts).[6] When investors receive profits, they also pay capital gains or dividend taxes. S-corps and other pass-through entities don't pay corporate income taxes (although S-corps in Massachusetts with receipts over $6 million pay an S-corp tax on profits of up to 2.9 percent or up to 3.9 percent if they are financial institutions).

Instead, profits of pass-through businesses are attributed to the owners who then pay ordinary income taxes on those profits when the profits are earned by the business. Unlike owners of C-corps, owners of pass-through entities do not pay a separate dividend tax when the profits are distributed.

Like the income tax on C-corps, the individual tax paid on S-corp and other pass-through income is paid only on profits: net income after expenses. If an S-corp has $10 million in gross revenue and $9.5 million in expenses, the owners of the S-corp pay taxes only on the $500,000 in profits. If the S-corp hires additional people during the year and spends the $500,000 that would have been profits, then the S-corp would have no profits and the owners would owe no tax. While there have been reports in the media[7] of S-corp owners suggesting that they would invest substantially less in their businesses if the tax on profits increased modestly, academic studies of the effects of personal income tax rates on state economic performance find little or no adverse effects.[8] In contrast, there is significant evidence that effective public investments in education and infrastructure can strengthen a state economy.[9]

If Massachusetts had a higher tax rate on incomes over $1 million, then owners of S-corps and other pass-through entities with more than a million dollars of individual income (including pass-through profits) would pay the additional 4 percent on the income over one million dollars a year. Those with less than a million dollars a year in taxable income would not be affected. Nationally, over 98 percent of those reporting pass-through income have taxable income under a million dollars a year.[10]

President Trump has proposed to cut taxes for pass-through income below the tax rate on other forms of income. The President has proposed a top rate of 15 percent on this income, rather than the top rate for other forms of income (up to 39.6 percent). This tax break would cost the United States $1.5 trillion over ten years and the significant majority of the benefits would go to the highest-income one percent of the population.[11]

How Are S-Corps Taxed in Other States?

In most other states, including those that tax high-income taxpayers at relatively high rates, such as California, New York, Oregon, Iowa, New Jersey, Minnesota, Vermont, and Maryland (which have top tax rates over 8 percent), high-income owners of S-corps and other pass-though businesses pay income taxes at those higher rates on their pass-through income. In California (as in Massachusetts), there is an additional S-corp tax (1.5 percent in California).

These states that currently have higher tax rates on very high-income taxpayers have not found it necessary to create any special tax breaks for owners of S-corps. In recent years, Kansas did adopt a special tax break for pass-through income. That experiment appears to have failed.

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[1] Center on Budget and Policy Priorities, "Trump's Pass-Through Proposal: New Figures on High-End Tax Cuts" Mar 15, 2017.
[2] *Boston Business Journal*, "Millionaire's Tax or Business Tax?" April 14, 2017.
[3] Center on Budget and Policy Priorities, "Kansas Tax Cut Experience Refutes Economic Growth Predictions," May 2016.
[4] Fox Business, "Kansas Legislators Repudiate Governor, Override Tax Veto," June 7, 2017.
[5] Internal Revenue Service, "Choosing a Business Service," FS-2008-22.
[6] Tax Policy Center, "Corporate Rate schedule" and State Corporate Income Tax Rates," (Mar. 2017).
[7] *Boston Business Journal*, "Millionaire's Tax or Business Tax?" Apr. 14, 2017.
[8] *National Tax Journal*, "The Relationship Between Taxes and Growth at the State Level: New Evidence" (Dec. 2015); and Center on Budget and Policy Priorities, "State Personal Income Tax Cuts: Still a Poor Strategy for Economic Growth" (May 2015).
[9] MassBudget, "Building a Strong Economy: The Roles of Education Transportation, and Tax Policy" (Jan. 2016).
[10] Tax Policy Center, "Distribution of Business Income" (Table T17-0076) Mar. 2017.
[11] Center on Budget and Policy Priorities, "GOP Tax Plans Would Emulate Failed Kansas Experiment" (June 7, 2017).