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Taxing Large Pass-Throughs As Corporations: How Many Firms Would Be Affected?

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Summary

Several lawmakers and the Obama Administration have expressed interest in taxing large partnerships and S corporations, also known as pass-throughs, as corporations. Part of this interest appears to be related to deficit and debt concerns. Pass-throughs may be a source of revenue since they currently account for over half of all business income but generally pay no corporate tax. Additionally, there is a growing concern that the current business tax environment may be inequitable and inefficient. Today, two business that are otherwise identical except that one is a corporation and the other is a pass-through are taxed differently. This disparity could be viewed as inequitable since the companies are similarly positioned to pay taxes. Additionally, the lack of tax uniformity across business types may cause an inefficient allocation of resources if business decisions are made for tax reasons and not economic reasons.

This report uses aggregate and industry-level tax data to analyze how many partnerships and S corporations could be subject to the corporate tax. It is estimated that if a receipt-based measure of size is used, then between 0.3% and 1.5% of S corporations and partnerships could be taxed as corporations depending on if a "large" pass-through is defined as one with receipts exceeding $50 million or exceeding $10 million. Using an asset-based measure of size produces similar estimates. It is estimated that between 0.3% and 1.0% of pass-throughs could pay the corporate tax depending on whether a $100 million or $25 million asset threshold is used to define a "large" firm.

Although estimates suggest that only a small percentage of pass-throughs could be considered large for corporate tax purposes, this report also finds that those firms are responsible for a significant amount of economic activity, indicating that the proposed policy change could raise substantial revenue. For example, 30% of S corporation receipts are generated by the largest 0.3% of S corporations, and 41% of partnership receipts are generated by the largest 0.2% of partnerships. Similarly, the largest 0.2% of S corporations hold 43% of S corporation assets, while the largest 1.1% of partnerships hold 78% of partnership assets.

Taxing large pass-throughs as corporations would also allow for lower tax rates as it would broaden the corporate tax base. Lower tax rates combined with a reduction in the tax disparity between the corporate and non-corporate sectors could improve business tax equity and the allocation of resources relative to current policy. At the same time, an alternative policy prescription that is generally more appealing to economists—integration of the corporate and individual tax systems—could also achieve these objectives. If integration is not possible, however, then reducing the tax discrepancy between large pass-throughs and corporations may be another viable alternative, depending on its design.

The focus on businesses is not the only perspective when it comes to changing the tax treatment of pass-throughs. CRS Report R42359, *Who Earns Pass-Through Business Income? An Analysis of Individual Tax Return Data*, by Mark P. Keightley, examined the issue of pass-through taxation from the perspective of individual taxpayers. That report concluded that although the corporate tax would be levied on pass-throughs, individuals would bear the full burden of the tax since businesses are legal, not physical entities. In addition, the analysis in that report suggests that higher-income taxpayers would generally bear most of the burden from increased pass-through taxes because they earn the majority of pass-through income and are limited in their ability to shift the burden to lower-income taxpayers.

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Several lawmakers and the Obama Administration have recently expressed interest in taxing large partnerships and S corporations, also known as pass-throughs, as corporations. In early 2011, Senate Finance Committee Chairman Max Baucus suggested the possibility of taxing pass-throughs earning above a certain income as corporations.[1] That same year, Treasury Secretary Tim Geithner said "Congress has to revisit this basic question about whether it makes sense for us as a country to allow certain businesses to choose whether they're treated as corporations for tax purposes or not."[2] Most recently the President proposed creating parity in the tax treatment of large corporate and non-corporate businesses.[3] House Ways and Means Committee Chairman Dave Camp, however, has expressed his opposition to such a policy change.[4]

Two concerns appear to be driving the interest in taxing large pass-throughs as corporations. First, projected deficit and debt increases have highlighted the possible need for revenue increases. Pass-throughs may be a source of revenue since they currently comprise over half of all business income but generally pay no corporate tax.[5] Instead, the income of these companies, as the name suggests, "passes through" the business directly to the owners where it is taxed according to individual tax rates.[6] Although no official revenue estimates exist, calculations by economist Martin Sullivan suggest that federal tax revenues may be between $13 billion and $47 billion lower annually than could otherwise be expected because of the shift away from the corporate form towards the pass-through forms.[7] The shift has led to a reduction in corporate tax revenues, which has not been completely offset by increased individual tax revenue.

Second, discussions of tax reform have expressed concern about the equity, efficiency, and complexity of the general business tax environment in existence today, and in some cases the distinction between corporate and non-corporate businesses specifically.[8] Today, two businesses

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[1] Nicola M. White and Drew Pierson, "Baucus Says Congress Should Look at Taxing Passthroughs as Corporations," *Tax Notes Today*, May 5, 2011.

[2] See Senate hearing testimony by Treasury Secretary Timothy Geithner. U.S. Congress, Senate Committee on Finance, The President's Budget for Fiscal Year 2012, 112th Cong., February 16, 2011.

[3] A Joint Report by the White House and the Department of the Treasury Department, *The President's Framework for Business Tax Reform*, Washington, DC, February 2012, p. 10, http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf.

[4] Bernie Becker, "Members eager for White House tax plan," *The Hill*, May 4, 2011, Online edition, http://thehill.com/business-a-lobbying/159351-lawmakers-eager-for-white-house-tax-plan-.

[5] The income of a pass-through income can be subject to the corporate tax if the pass-through is a subsidiary of a corporate parent.

[6] For more information on the taxation of various business forms, see CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by Mark P. Keightley.

[7] Sullivan estimates that gross corporate tax revenues would be $40 billion higher if the corporate sector's share of business activity remained the same as it was in 1999. Assuming the corporate sector's share of business activity remained the same as it was in 1990, Sullivan estimates that gross corporate tax revenues would be $140 billion higher. Since the shift from corporate to pass-through form implies that businesses are generating more tax revenue under the individual income tax, the above figures do not represent the net revenue loss to the federal government. Sullivan states that "back-of-the-envelope calculations suggest that the net revenue loss to the government is probably more like one-third of the gross figure." Multiplying $40 billion and $140 billion by one third produces the figures cited above. Martin A. Sullivan , "Passthroughs Shrink the Corporate Tax by $140 Billion," *Tax Notes*, February 28, 2011, pp. 987-989.

[8] Nearly all major tax reform proposal released recently have called for some kind of base broadening which can be used to reduce tax rates with the aim of improving the business tax environment. The President's Economic Recovery and Advisory Board specifically calls for examining the distinction between corporate and non-corporate forms, along with general base broadening, lower tax rates, and reduced complexity. See, President's Economic Recovery and (continued...)

that are otherwise identical other than that one is a corporation and one is a pass-through are taxed differently. This disparity could be viewed as inequitable since the firms are similarly positioned to pay taxes. Additionally, the lack of tax uniformity across business types is believed to result in too much investment in the non-corporate sector where the after-tax return on investment is higher.[9] Taxing large pass-throughs as corporations, when combined with other reform proposals such as eliminating or reducing corporate tax preferences and loopholes, would broaden the corporate tax base and allow for lower tax rates. These changes could potentially increase economic efficiency relative to the current policy. Estimates by CRS suggest that limiting the ability to avoid corporate taxation could potentially broaden the base enough to allow for a revenue-neutral corporate rate reduction of three percentage points.[10]

This report uses aggregate and industry-level tax data to analyze how many partnerships and S corporations could be subject to the corporate tax. Analysis of the data suggests that between 0.3% and 1.5% of all partnerships and S corporations could be taxed as corporations depending on what constitutes a "large" pass-through. Although this fraction is a relatively small share of pass-throughs, this report also indicates that these largest pass-throughs account for a disproportionate share of receipts and assets. Thus, while only a small number of firms may be affected by such a proposed policy change, the revenue generated could potentially be significant.

There are alternative policy prescriptions that can promote business tax uniformity and increase efficiency. Integrating the corporate and individual tax systems so that all business income is only taxed once is one such alternative. Integration would promote tax uniformity since all businesses would be taxed equally. Integration could also increase efficiency by removing a layer of taxation as well as possibly other distorting features of the corporate tax. For these reasons integration is generally appealing to economists. If, for whatever reason, integration is not possible, then reducing the tax discrepancy between large pass-throughs and corporations may be a viable policy alternative. The various design and administrative issues surrounding tax integration, however, put an analysis of such a proposal beyond the scope of this report.[11]

The impact on businesses is not the only perspective one can take when it comes to changing the tax treatment of pass-throughs. CRS Report R42359, *Who Earns Pass-Through Business Income? An Analysis of Individual Tax Return Data*, by Mark P. Keightley examined the issue of pass-through taxation from the perspective of individual taxpayers. That report concluded that

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Advisory Board, *The Report on Tax Reform Options: Simplicity, Compliance, and Corporate Taxation*, Washington, DC, August 2010, http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf. For a summary of other recent tax reform proposals see, CRS Report R41591, *Tax Reform: An Overview of Proposals in the 112th Congress*, by James M. Bickley. On March 7, 2012, the House Committee on Ways and Means held a hearing on the issue of pass-throughs taxation in the context of tax reform. Testimony given at that hearing may be found at http://waysandmeans.house.gov/Calendar/EventSingle.aspx?EventID=282644.

[9] See Jane G. Gravelle, *The Economic Effects of Taxing Capital Income* (MIT Press, 1994), pp. 77-82, and James B. Mackie, "Unfinished Business of the 1986 Tax Reform Act: An Effective Tax Rate Analysis of Current Issues in the Taxation of Capital Income," *National Tax Journal*, vol. 55, no. 2 (June 2002), pp. 293-337.

[10] CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by Jane G. Gravelle.

[11] In 1992, The Department of the Treasury drafted a 268 page report containing a comprehensive analysis of corporate and individual tax integration. See, The Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, Washington, DC, January 1992, http://www.treasury.gov/resource-center/tax-policy/Documents/integration.pdf. For a summary of the Treasury report, see R. Glenn Hubbard, "Corporate Tax Integration: A View from the Treasury Department," *Journal of Economic Perspectives*, vol. 7, no. 1 (Winter 1993), pp. 115-132.

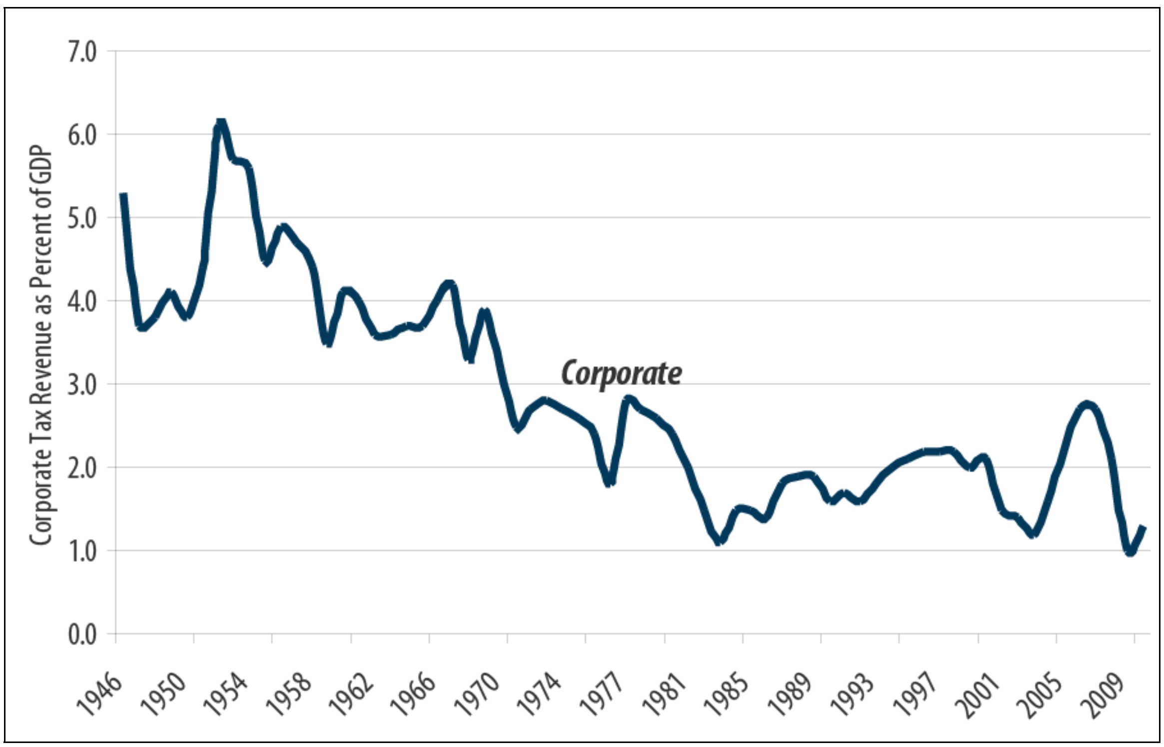
although the corporate tax would be levied on pass-throughs, individuals would bear the full burden of the tax since businesses are legal, not physical entities. In addition, the analysis in that report suggests that higher-income taxpayers would generally bear most of the burden from increased pass-through taxes because they earn the majority of pass-through income and are limited in their ability to shift the burden to lower-income taxpayers.

The remainder of this report is organized as follows. First, a brief overview of tax revenue and trends in business organization is presented. Next, pass-throughs are compared with their corporate counterparts. Aggregate and industry-level estimates of the number of partnerships and S corporations that could be taxed as corporations are then presented. Finally, policy options and considerations are reviewed.

Trends in Tax Revenue and Business Organization

Part of the interest in taxing large pass-throughs as corporations stems from the decline in corporate tax revenue. In the post-World War II era, corporate tax revenue as a share of gross domestic product (GDP) peaked in 1952 at 6.1% and has generally declined since (see **Figure 1**). Today, the corporate tax generates revenue equal to approximately 1.3% of GDP, although projections (not shown here) have the corporate tax revenue rising to 2.4% of GDP in several years as the economy recovers and temporary investment incentives (bonus depreciation) expire. Despite this decline, an increase in payroll tax revenue from 1.4% of GDP in 1946 to 6.0% in 2010 has helped to support overall federal tax revenue.

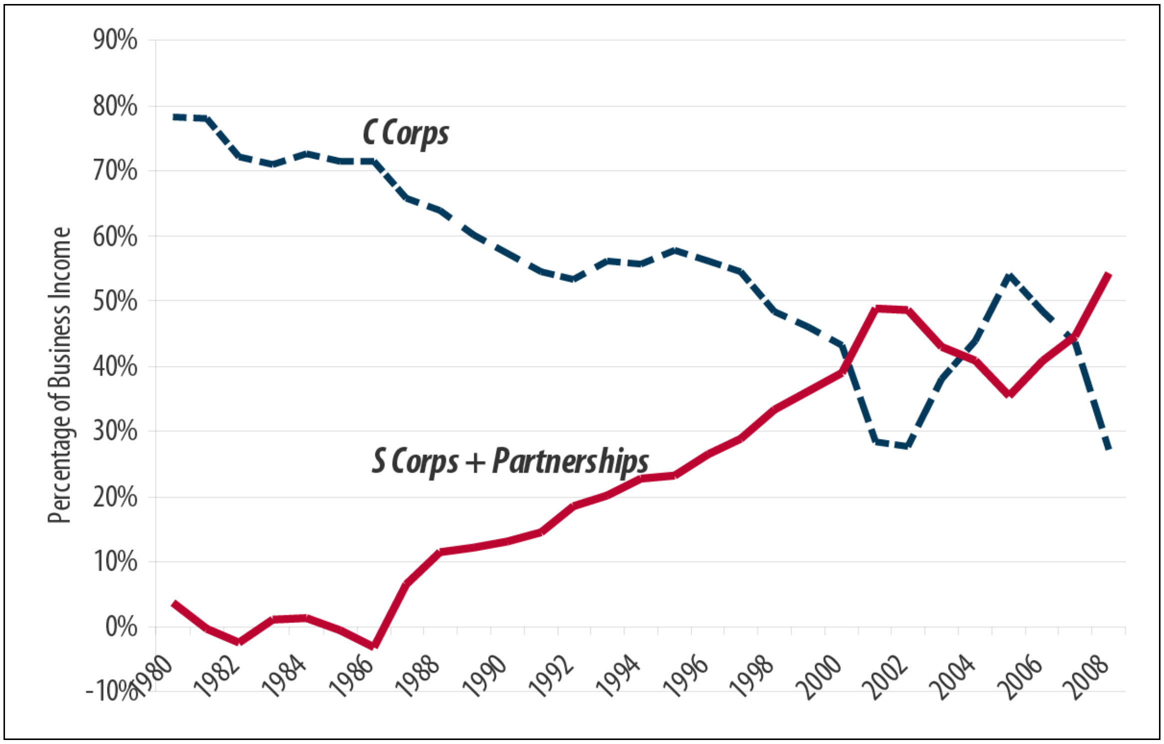
Figure 1. Corporate Tax Revenue As a Percentage of GDP, 1946-2010



Source: Office of Management and Budget, Table 2.3, http://www.whitehouse.gov/omb/budget/Historicals.

A number of reasons for the decline in corporate tax revenues have been indentified (see CRS Report R42113, *Reasons for the Decline in Corporate Tax Revenues*, by Mark P. Keightley). First, the average effective corporate tax rate has decreased over time, mostly as a result of reductions in the statutory rate and changes affecting the tax treatment of investment and capital recovery (depreciation). Second, corporate-sector profitability has fallen over time, which has eroded the corporate tax base. And third, an increasing fraction of business activity has shifted to partnerships and S corporations, which are not subject to the corporate income tax, further eroding the corporate tax base.

Figure 2. Net Business Income By Business Type, 1980-2008



Source: Internal Revenue Service, Statistics of Income, Integrated Business Data, http://www.irs.gov/pub/irs-soi/80ot1all.xls.

Notes: Data excludes regulated investment companies (RICs) and Real Estate Investment Trusts (REITs). Sole proprietorships were included in computing aggregate net business income for purposes of determine the distribution shown. Sole proprietorships, however, are overwhelmingly small business and would not likely be subject to the corporate tax. Thus, they are excluded from the figure.

Figure 2 shows just how significant the shift in business activity has been. In 1980, C corporations generated 78% of net business income in the United States. By 2008 however, the corporate sector was responsible for only 27% of all business income. Over the same time period, the share of income attributable to partnerships and S corporations grew from 4% to 54%.[12] These trends are partly due to the Tax Reform Act of 1986 (TRA86), which increased the attractiveness of choosing a pass-through form over the corporate form by lowering the highest individual income tax rate six percentage points below the highest corporate income tax rate.[13] Additional

[12] Sole proprietors are responsible for the remaining share of business income.

[13] Prior to TRA86, the highest individual income tax rate was 50%, whereas the highest corporate income tax rate was (continued...)

legislative changes in the early 1990s allowed S corporations to have more shareholders, and that same decade regulatory changes enabled LLCs to be taxed as partnerships. These policy changes increased the attractiveness of pass-throughs and, in the case of the S corporation shareholder limit increase, allowed them to be larger.

Comparing Large Pass-Throughs and Corporations

How do large pass-throughs compare with corporations? This question is slightly more complicated than it appears since there are several different ways to measure firm size. Size could be measured by employment, profits, assets, or a variety of other statistics. Additionally, two different industries may require different measures of size. For example, one industry may be more capital intensive than another, leading firms in that industry to naturally have more assets, whereas firms in another industry may generally have fewer assets while still employing a large number of workers. Data availability, however, limits the analysis presented here to using just two different measures of firm size—a receipt-based measure and an asset-based measure.

Size Based on Receipts

Table 1 compares large S corporations and partnerships with large corporations based on business receipts. The table displays data for two different categories of firm size—firms with receipts between $10 million and $50 million, and firms with receipts over $50 million. The $10 million to $50 million category arguably contains some firms that many would not consider large since $10 million in receipts is right on the boundary between the definition of a small and medium size business. However, refinement of the size thresholds is impossible since the IRS has already organized the data in this fashion. Still, the category contains some larger pass-throughs since it includes firms with receipts up to $50 million. Without knowing exactly where the receipt threshold may be for the tax it is useful to compare business across both size categories.

Table 1 shows that there were more pass-throughs (87,674) than corporations (67,144) with receipts above $10 million. There were also nearly as many pass-throughs (15,360) as corporations (16,516) with receipts exceeding $50 million. These figures are not too surprising since there are more S corporations and partnerships than C corporations in total. These figures do, however, highlight an important fact that is often overlooked—the term pass-through is not necessarily synonymous with the term "small business."

The data also show that average receipts of medium to large size pass-throughs (firms with receipts of $10 million to $50 million) are nearly identical to average receipts of similar sized corporations. This makes sense given that **Table 1** groups the data according to receipts. There is, however, a noticeable difference in the average receipts of the largest pass-throughs and corporations. For corporations with receipts over $50 million, average receipts are nearly $700 million, while the largest S corporations average receipts of $128 million, and the largest partnerships average receipts of $302 million. Thus, while there are a significant number of large

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46%. TRA86 eventually lowered the highest individual tax rate to 28% and the highest corporate tax rate to 34%. An IRS study found that the more favorable tax treatment under the individual tax schedule after TRA86 induced certain businesses organized as C corporations to reorganize as S corporations. See Susan M. Whittman and Amy Gill, "S Corporation Elections After the Tax Reform Act of 1986," SOI Bulletin, publication 1136 (Spring 1998).

pass-throughs, the largest corporations, when measured by receipts, are over five times larger than the average S corporation, and more than twice as large as the average partnership.

Table 1. Comparison of Large Pass-Throughs and Corporations Based on Business Receipts, 2003

(money amounts are measured in thousands of dollars)

	$10 million under $50 million	Over $50 million
C corporations:		
Number of firms	50,628	16,516
Average business receipts	$18,413	$711,304
% of all C corporations	2.5%	0.8%
% of total C corporation receipts	7%	83%
S corporations:		
Number of firms	52,898	9,757
Average business receipts	$20,739	$128,387
% of all S corporations	1.6%	0.3%
% of total S corporation receipts	26%	30%
Partnerships:		
Number of firms	19,416	5,603
Average business receipts	$18,159	$302,106
% of all partnerships	0.8%	0.2%
% of total partnership receipts	8%	41%

Source: CRS calculations using Internal Revenue Service's 2003 Statistics of Income (SOI) Integrated Business Database (IBD), table 2, http://www.irs.gov/pub/irs-soi/03ot2busbr.xls.

Note: The most recent data available that contain information on firm size measured by receipts for all three business types are from 2003.

Another similarity between pass-throughs and corporations is the concentration of receipts among a very small percentage of large firms. About 30% of S corporation receipts are generated by the largest 0.3% of S corporations, and 41% of partnership receipts are generated by the largest 0.2% of partnerships. In comparison, the largest 0.8% of corporations are responsible for 83% of corporate receipts, indicating that there is an even greater concentration of receipts among the largest corporations than there is among the largest pass-throughs. Including firms with receipts between $10 million and $50 million increases the fraction of activity concentrated among large pass-throughs and corporations. Thus, while only a small percentage of partnerships and S corporations could be considered large and therefore subject to the corporate tax, these large pass-throughs could potentially generate a significant amount of tax revenue because they account for a disproportionate share of pass-through business activity.

Size Based on Assets

The similarities between large pass-throughs and large corporations extend to a comparison based on total assets. **Table 2** shows that there are at least as many S corporations and partnerships (combined) as C corporations in each of the three size categories. In 2008, there were 39,389 pass-throughs with assets above $50 million, compared with 27,807 corporations; there were 21,056 pass-throughs with assets exceeding $100 million, compared with 20,519 corporations of the same size. As in the case of a receipt-based comparison, these figures run contrary to the general association of pass-throughs with "small business."

Table 2. Comparison of Large Pass-Throughs and Corporations Based on Assets, 2008

(money amounts are measured in thousands of dollars)

	$25 million under $50 million	$50 million under $100 million	Over $100 million
C corporations:			
Number of returns	9,377	7,288	20,519
Average assets	$35,486	$71,419	$3,483,793
% of C corporations	0.5%	0.4%	1.1%
% of C corporation assets	1%	1%	97%
S corporations:			
Number of returns	7,551	3,611	3,326
Average assets	$34,471	$69,424	$361,250
% of S corporations	0.2%	0.1%	0.1%
% of S corporation assets	8%	7%	36%
Partnerships:			
Number of returns	25,072	14,272	18,180
Average assets	$34,811	$69,711	$773,236
% of Partnerships	0.8%	0.5%	0.6%
% of Partnership assets	5%	5%	73%

Source: CRS calculations using Internal Revenue Service's SOI, Table Wizard, http://www.taxstatstablewizard.com, and Statistics of Income Tax Stats, Partnership Statistics, http://www.irs.gov/taxstats/bustaxstats/article/0,,id=97153,00.html.

An asset-based comparison also shows that the largest corporations are, again, much larger than the largest pass-throughs. For corporations with assets over $100 million, average assets equal nearly $3.5 billion, while the largest S corporations average assets of $361 million, and the largest partnerships average assets of $773 million. Although there are a significant number of large pass-throughs, the largest corporations are about 4.5 times larger than the average S corporation, and about 10 times larger than the average partnership. This difference between the largest corporations and pass-throughs may be partly due to corporations' access to larger capital markets with which to finance assets.

Table 2 also indicates that there is a concentration of assets among a small number of firms that is similar to the concentration of receipts displayed in **Table 1**. For example, 43% of S corporation assets are held by the largest 0.2% of firms, and 78% of partnership assets are held by the largest 1.1% of firms. Once again, the distribution is even more concentrated for corporations—98% of corporate assets are held by the largest 1.5% of firms. Thus, although only a small percentage of firms could be considered large for corporate tax purposes, they generate a significant amount of economic activity, and therefore possibly revenue.

Small Pass-Throughs and Corporations

While the analysis above focused on the similarities between large pass-throughs and corporations, there are similarities across pass-throughs and corporations more generally. Perhaps most notable, the majority of *both* pass-throughs and corporations are small, when measured by assets or receipts. The same data used to construct **Table 1** also show that over 95% of partnerships, S corporations, and C corporations generated receipts of less than $10 million.[14] Similarly, the data used in **Table 2** show that over 95% of S and C corporations and over 90% of partnerships have assets under $5 million.[15] The differing tax treatment of these smaller businesses raises the same efficiency and equity concerns that are part of the impetus for the current debate. Addressing these concerns, however, would likely require a comprehensive reform of business taxation.

Estimated Number of Firms Affected

Estimates of the number of pass-throughs that could be taxed as corporations can be made by employing the same data used to construct **Table 1** and **Table 2**. Because those tables define size in two ways, two different sets of estimates are presented—one based on a receipt measure of size and a second based on an asset measure of size. Industry-specific estimates are also presented. The industry-level data needed to construct such estimates for partnerships based on an asset measure of size, however, are not available. Only asset-based estimates for S corporations are presented.

Aggregate Estimates

Table 3 displays the estimated number of partnerships and S corporations that could be subject to the corporate tax if size is measured by receipts. It is estimated that between 0.3% and 1.5% of all pass-throughs could be taxed as corporations if a receipt-based measure of size is used. In absolute terms, this corresponds to between 15,360 and 87,674 pass-throughs being subject to the

[14] Author's calculations using 2003 SOI data.

[15] Author's calculations using 2008 SOI data.

corporate tax. More S corporations than partnerships would be affected, in absolute and percentage terms, because S corporations tend to be larger on average than partnerships when size is measured by receipts. Between 0.3% and 1.9% (9,757 and 62,655) of S corporations could potentially be subject to the corporate tax, compared with 0.2% to 1.1% (5,603 and 25,019) of partnerships.

Table 3. Estimated Number of Pass-Throughs Potentially Taxed As Corporations Based on Receipts, 2003

	Over $10 Million		Over $50 Million	
	Firms	**% of Total**	**Firms**	**% of Total**
S corporations	62,655	1.9%	9,757	0.3%
Partnerships	25,019	1.1%	5,603	0.2%
Total	87,674	1.5%	15,360	0.3%

Source: CRS calculations using Internal Revenue Service's 2003 Statistics of Income (SOI) Integrated Business Database (IBD), table 2, http://www.irs.gov/pub/irs-soi/03ot2busbr.xls.

An asset-based measure of size produces similar estimates to those using a receipt-based measure. **Table 4** shows between 0.3% and 1.0% of all pass-throughs could be subject to the corporate tax depending on the asset threshold chosen to determine "large" firms. In contrast to the receipt-based estimates, using an asset-based measure of size results in more partnerships than S corporations being affected. This is because partnerships tend to be larger (in terms of assets) than S corporations on average. Between 0.6% and 1.8% (18,180 to 57,524) of partnerships could potentially be subject to the corporate tax, compared with 0.08% to 0.4% (3,326 to 14,888) of S corporations.

Table 4. Estimated Number of Pass-Throughs Potentially Taxed As Corporations Based on Assets, 2008

	Over $25 Million		Over $50 Million		Over $100 Million	
	Firms	**% of Total**	**Firms**	**% of Total**	**Firms**	**% of Total**
S corporations	14,488	0.4%	6,937	0.2%	3,326	0.1%
Partnerships	57,524	1.8%	32,452	1.0%	18,180	0.6%
Total	72,012	1.0%	39,389	0.5%	21,506	0.3%

Source: CRS calculations using Internal Revenue Service, SOI, Table Wizard, http://www.taxstatstablewizard.com, and SOI, Partnership Statistics, http://www.irs.gov/taxstats/bustaxstats/article/0,,id=97153,00.html.

Table 3 and **Table 4** do not accurately describe the potential of the proposed policy change to obtain one of its objectives—raise tax revenue. While the estimates above suggest that only a relatively small fraction of pass-throughs could be subject to the corporate tax, they do not show the economic significance of the firms potentially affected. The previous section, however, showed that the largest pass-throughs account for a disproportionate share of receipts, and held a disproportionate share of assets (see **Table 1** and **Table 2**). Thus, while only a small number of firms may be impacted by the corporate tax, the revenue generated could potentially be significant since the affected firms would be large.

Industry-Level Estimates

It is also possible to estimate the number of firms in each industry that could potentially be subject to the corporate tax. **Table 5** displays the five industries that would likely be the most affected if large pass-throughs were taxed as corporations based on their receipts. The rankings were made based on the percentage of firms in each industry that would be affected if the size threshold were $10 million in receipts. There are 18 industry classifications in total. **Appendix A** contains estimates for all 18 industries.

Table 5. Five Industries Most Affected by Corporate Tax Based on Receipts, 2003

	Over $10 Million		Over $50 Million	
	Firms	**% of Industry**	**Firms**	**% of Industry**
S corporations:				
Manufacturing	9,443	6.30%	1,536	1.03%
Wholesale\retail trade	28,491	5.02%	5,508	0.97%
Mining	400	2.40%	50	0.30%
Transportation	2,273	2.20%	207	0.20%
Construction	9,581	2.14%	1,123	0.25%
Partnerships:				
Utilities	395	15.86%	211	8.47%
Manufacturing	2,756	6.83%	905	2.24%
Information	1,014	3.19%	360	1.13%
Wholesale\retail trade	5,028	2.94%	575	0.34%
Health care	1,571	2.90%	190	0.35%

Source: CRS calculations using Internal Revenue Service's 2003 Statistics of Income (SOI) Integrated Business Database (IBD), table 2, http://www.irs.gov/pub/irs-soi/03ot2busbr.xls.

Manufacturing and wholesale and retail trade would likely have the largest percentage of firms subject to the corporate tax among S corporations. It appears that over 5% of both industries would be taxed if the size threshold were set at $10 million, and just around 1% of both industries would be taxed if it were set at $50 million. Mining, transportation, and construction likely round out the top five S corporations, with about 2% being affected at the $10 million size cutoff, and 0.30% or less being taxed at a $50 million cutoff.

The utilities industries would likely be most affected among partnerships, followed by manufacturing. Nearly 16% of the utilities industry could pay the corporate tax if a $10 million threshold were used. Around 8.5% of the industry could pay the tax if the size limit were increased to $50 million. With respect to manufacturing, just under of 7% could be taxed as corporations if the smaller size definition were used, and just over 2% could pay the tax if the larger $50 million threshold were chosen. Information, wholesale and retail trade, and health care appear to make up the remaining top five most affected partnership industries.

Table 6. Five Industries Most Affected by Corporate Tax Based on Assets, 2008

	Over $25 Million		Over $50 Million		Over $100 Million	
	Firms	% of Industry	Firms	% of Industry	Firms	% of Industry
S corporations:						
Holding Companies	2,191	9.6%	1,706	7.4%	1,163	5.1%
Manufacturing	2361	1.5%	970	0.6%	416	0.3%
Mining	303	1.2%	153	0.6%	66	0.3%
Utilities	26	0.9%	15	0.5%	7	0.2%
Finance/Insurance	1,175	0.7%	712	0.4%	377	0.2%

Source: CRS calculations using Internal Revenue Service, SOI, Table Wizard, http://www.taxstatstablewizard.com, and SOI, Partnership Statistics, http://www.irs.gov/taxstats/bustaxstats/article/0,,id=97153,00.html.

Industry-level estimates of the number of firms that could be affected if an asset-based measure of size were used are presented in **Table 6**. Industry estimates can only be made for S corporations, however, since industry-level data on partnership asset holdings do not exist. The rankings were made based on the percentage of firms in each industry that would be affected if the size threshold were $25 million in assets. **Appendix B** provide estimates for all 18 industry classifications.

It is estimated that holding companies would be most affected.[16] Between 5.1% and 9.6% of S corporation holding companies could be subject to the corporate tax depending on the asset threshold used. Manufacturing ranks second, with between 0.3% and 1.5% of S corporations in the industry potentially affected. Mining, utilities, and the finance and insurance industry appear to round out the top five. **Table 6** also indicates that as the size threshold increases, the number of potentially affected firms across industries falls. For the largest size measure, the number of firms falls to less than 2% for all industries except holding companies.

Lastly, comparing **Table 5** and **Table 6** reveals that the measure of size used matters for determining what industries will be affected the most. For example, while holding companies are estimated as the most affected if an asset-based measure of size is used, the industry does not even break the top five if a receipt-based measure of size is used. The decision about how to measure size becomes less important as the minimum size used to determine which firms would be subject to the corporate tax increases. For instance, aside from S corporation holding companies, if a $100 million asset threshold were used, no industry would see more than 0.3% of firms taxed as corporations. If a $50 million receipt threshold were used, only two industries would have more than 0.3% of firms paying the corporate tax.

[16] A holding company owns other businesses which may produce goods or provide services, although the holding company itself does not. Included in the holding company industry are bank, financial, and insurance holding companies, as well as public utility holding companies and others.

Policy Choices and Considerations

Congress will face a number of policy choices and considerations should it choose to tax large pass-throughs as corporations. One choice would concern the size of a pass-through that would trigger the corporate tax. This involves two steps. First, a measure of business size would need to be chosen. Two measures were used in this report—an asset-based measure and a receipt-based measure. Alternatives to these two options include a profit-based measure, an employment-based measure, a composite measure (i.e., based on assets, receipts, and employment), or industry specific measures (e.g., an asset-based measure for certain industries, and a receipt-based measure for other industries).

An asset-based measure has some attractive features. Assets are likely to be more stable over the business cycle than revenues, profits, and employment. Therefore, using an asset-based measure would help to reduce uncertainty about how a business will be taxed in any given year. It may also be harder for pass-throughs to manipulate their assets to avoid being labeled as large. The most sophisticated pass-throughs may be able to shift revenue or income to subsidiaries located outside the U.S. in an attempt to avoid the corporate tax. At the same time, certain firms may still be able to strategically shift assets out of the country to avoid the corporate tax. There is some evidence that firms with extensive intangible assets (e.g., patients, copy rights, trademarks, etc.), such as those in the pharmaceutical industry, and the computer and electronic equipment industry, may be engaged in this behavior.[17]

An asset-based measure of size, however, may not accurately measure the economic size of businesses in particular industries. Certain firms and industries may be less capital intensive than others and therefore have fewer assets. For example, the manufacturing and mining industries will naturally have more assets than the health care industry, or the education industry because these two industries are more service-oriented. Particular health care and education firms could still be considered large if measured by receipts, profits, or employment, but may not be classified as such when measured by assets.

An alternative to using a single measure of size would be to use a composite measure of size that is based on assets, employment, and revenue or income. Another option would be to use industry specific measures, such as an asset-based measure for the manufacturing industry, and a receipt or profit-based measure for the health care industry. In any case, if policymakers decide to use a measure based on receipts, profits, or employment, they may want to consider using an multi-year moving average since these measure may fluctuate substantially from year to year.

The second step in defining "large" pass-throughs is choosing a threshold above which a pass-through would be taxed as a corporation. The Obama Administration may be considering a proposal that would define a large pass-through as one earning $50 million or more in receipts.[18] The Administration has also considered using an industry-specific threshold to impose a financial crisis responsibility fee on large financial institutions. This threshold would be asset based and set at $50 billion, which would be suitable for indentifying large financial institutions.[19] However,

[17] See CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle for a discussion of intangible asset transfers and corporate tax avoidance.

[18] Martin A. Sullivan, "Why Not Tax Large Passthroughs as Corporations," *Tax Notes*, June 6, 2011, pp. 1015-1018.

[19] Office of Management and Budget, *Analytical Perspectives, Federal Receipts, Budget of the United States Government,*, Washington, DC, February 13, 2012, p. 204, http://www.whitehouse.gov/sites/default/files/omb/budget/ (continued...)

such a threshold may exclude firms in other industries that are considered large by alternative measures. One way to address this would be to employ industry-specific size thresholds. In determining the thresholds, Congress could direct the IRS to develop appropriate industry specific thresholds, or rely on methods similar to those already implemented by the Small Business Administration (SBA). Alternatively, Congress could specifically legislate the size measures and thresholds to be used to decide which pass-throughs must pay the corporate tax.[20]

Congress could also opt to exempt pass-throughs in certain industries. Again, though, economic theory generally calls for uniform tax treatment across industries, although differential tax treatment may be justified when the actions of firms in certain industries bestow benefits to or impose costs on society that are not reflected in market prices. Examples include research and development (benefit or positive spillover) and pollution (cost or negative spillover). Still, it would probably be more efficient to levy a uniform income tax and then use more precise policy tools (e.g., credits, deductions, grants, regulation, etc.) to target spillovers at the firm level. Additionally, by including all industries and thus broadening the corporate tax base as much as possible, corporate tax rates could potentially be reduced further, which may be more efficient and equitable than if certain industries were excluded.

Unfortunately, economic analysis does not provide any insight into the appropriate threshold used to define large firms. Economic theory would tend to suggest that any business tax system should tax all businesses—large and small—equally. The analysis in this report, particularly **Table 3** and **Table 4**, however, does provide estimates of the number of firms that would be subject to the corporate tax if particular size thresholds were chosen. These figures provide policymakers with a starting point from which to construct a more formal proposal if they should choose to do so.

Conclusion

This report used aggregate and industry-level individual tax return data to analyze how many partnerships and S corporations could be subject to the corporate tax. The analysis determined that if a receipt-based measure of size is used, then between 0.3% and 1.5% of S corporations and partnerships could be taxed as corporations depending on the definition of a "large" pass-through—either receipts exceeding $50 million or $10 million. Using an asset-based measure of size produces similar estimates. It is estimated that between 0.3% and 1.0% of pass-throughs could pay the corporate tax depending on whether a $100 million or $25 million asset threshold is used to define a "large" firm. Although estimates suggest that only a small percentage of pass-throughs could be considered large for corporate tax purposes, the affected firms are responsible for a significant amount of economic activity, indicating that the proposed policy change could potentially raise substantial revenue.

This report focused on the effect of changing the tax treatment of pass-throughs from the perspective of businesses. CRS Report R42359, *Who Earns Pass-Through Business Income? An Analysis of Individual Tax Return Data*, by Mark P. Keightley, examined the issue of pass-through taxation from the perspective of individual taxpayers. That report concluded that although the

(...continued)

fy2013/assets/receipts.pdf.

[20] For more information on the SBA, see CRS Report RL33243, *Small Business Administration: A Primer on Programs*, by Robert Jay Dilger.

corporate tax would be levied on pass-throughs, individuals would bear the full burden of the tax since businesses are legal, not physical entities. In addition, the analysis in the report suggests that higher-income taxpayers would generally bear most of the burden from increased pass-through taxes.

Appendix A. Industry-Level Estimates Using A Receipts-Based Measure of Size

Table A-1. Estimated Number of S Corporations Potentially Taxed As Corporations Based on Business Receipts, 2003

	Over $10 Million		Over $50 Million	
Industry	**Firms**	**% of Industry**	**Firms**	**% of Industry**
Manufacturing	9,443	6.30%	1,536	1.03%
Wholesale\retail trade	28,491	5.02%	5,508	0.97%
Mining	400	2.40%	50	0.30%
Transportation	2,273	2.20%	207	0.20%
Construction	9,581	2.14%	1,123	0.25%
Holding companies	378	1.69%	29	0.13%
Information	950	1.42%	104	0.16%
Waste management	1,687	1.00%	263	0.16%
Finance and insurance	1,157	0.86%	155	0.11%
Utilities	24	0.82%	13	0.44%
Agriculture, forestry, fishing, and hunting	583	0.72%	85	0.10%
Educational services	185	0.67%	12	0.04%
Health care	1,349	0.65%	211	0.10%
Professional, scientific, and technical services	3,149	0.61%	216	0.04%
Arts, entertainment, and recreation	401	0.54%	52	0.07%
Accommodation, food services, and drinking places	1,008	0.54%	92	0.05%
Real estate	1,065	0.29%	73	0.02%
Other services	531	0.27%	28	0.01%

Source: CRS calculations.

Table A-2. Estimated Number of Partnerships Potentially Taxed As Corporations Based on Business Receipts, 2003

	Over $10 Million		Over $50 Million	
Industry	**Firms**	**% of Industry**	**Firms**	**% of Industry**
Utilities	395	15.86%	211	8.47%
Manufacturing	2,756	6.83%	905	2.24%
Information	1,014	3.19%	360	1.13%
Wholesale\retail trade	5,028	2.94%	575	0.34%
Health care	1,571	2.90%	190	0.35%
Construction	3,008	2.14%	456	0.32%
Transportation	564	1.89%	144	0.48%
Mining	512	1.82%	132	0.47%
Accommodation, food services, and drinking places	1,293	1.59%	151	0.19%
Holding companies	335	1.55%	91	0.42%
Professional, scientific, and technical services	1,950	1.29%	471	0.31%
Finance and insurance	3,020	1.17%	682	0.26%
Waste management	424	0.97%	97	0.22%
Arts, entertainment, and recreation	355	0.82%	120	0.28%
Educational services	29	0.32%	6	0.07%
Agriculture, forestry, fishing, and hunting	369	0.30%	70	0.06%
Real estate	2,309	0.21%	256	0.02%
Other services	82	0.13%	24	0.04%

Source: CRS calculations.

Appendix B. Industry-Level Estimates Using An Asset-Based Measure of Size

Table B-1. Estimated Number of S Corporations Potentially Taxed As Corporations by Industry Based on Assets, 2008rations Potentially Taxed As Corporations by Industry Based on Assets, 2008

	Over $25 Million		Over $50 Million		Over $100 Million	
Industry	**Firms**	**% of Industry**	**Firms**	**% of Industry**	**Firms**	**% of Industry**
Holding companies	2,191	9.56%	1,706	7.4%	1,163	5.08%
Manufacturing	2,361	1.46%	153	0.6%	66	0.26%
Mining	303	1.21%	970	0.6%	416	0.26%
Utilities	26	0.92%	15	0.5%	7	0.25%
Finance/insurance	1,175	0.72%	712	0.4%	377	0.23%
Wholesale and retail trade	3,186	0.49%	1,209	0.19%	453	0.07%
Construction	2,088	0.37%	827	0.14%	292	0.05%
Agriculture, forestry, fishing, and hunting	278	0.34%	129	0.16%	54	0.07%
Information	235	0.32%	114	0.15%	51	0.07%
Transportation and warehousing	333	0.26%	158	0.12%	72	0.06%
Real estate	1,208	0.26%	470	0.10%	176	0.04%
Arts/ entertainment	152	0.17%	69	0.08%	40	0.04%
Waste Management	186	0.09%	95	0.05%	37	0.02%
Accommodation and food service	194	0.09%	84	0.04%	33	0.02%
Educational services	31	0.08%	12	0.03%	4	0.01%
Professional, scientific, and technical services	387	0.06%	149	0.02%	61	0.01%
Health care	110	0.04%	45	0.02%	18	0.01%
Other services	42	0.02%	18	0.01%	5	0.00%

Source: CRS calculations.

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