INFORMATION BRIEF
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Taxation and Small Businesses in Minnesota

Recent debates in the Minnesota Legislature on individual income tax proposals have focused on their impact on and implications for businesses that are taxed under the individual income tax. Most businesses are organized as sole proprietorships, partnerships, subchapter S corporations or limited liability companies (LLCs), and pay tax on their business income under the individual income tax. C corporations pay tax under the federal and state corporate taxes with their owner/investors also paying individual income tax on the dividends and capital gains they derive from the corporation.

This information brief gives an overview of the various forms of business organization and describes how they are taxed. In particular, it:

- Discusses the tax implications of the choice of business entity;
- Provides national and Minnesota data on entity type and business size; and
- Presents and discusses data on Minnesota returns that report partnership, S corporation, and sole proprietor income.

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Executive Summary

Owners of a small business can elect to operate in several different forms. They can organize and operate for tax purposes as one of the following:

- Corporation (C or S corporation)
- Partnership (general, limited, or limited liability)
- Limited liability company (LLC)
- Proprietorship (no explicit form of organization)

In general, "pass-through" taxation provides the most favorable treatment and most businesses opt for it.

A variety of tax, as well as legal and other business, considerations will affect which form a business chooses. C corporations' income is taxed twice, once under the corporate tax and again to the shareholder who receives the income as a dividend; by contrast, the income of S corporations and partnerships is "passed through" to their owners' individual tax returns and is taxed only once, while proprietor income is reported directly on the owner's individual return and also taxed only once. Thus, pass-through taxation or direct taxation as a proprietorship is favorable in that it avoids the two layers of tax that apply to C corporations. Since the top rates under the individual income tax are the same (federal) or lower (Minnesota) than under the corporate tax, there is little tax advantage to operating as a C corporation. However, public companies (firms whose stock is traded on a public stock exchange) generally must be C corporations.

Although they are all taxed on a pass-through basis, somewhat different tax rules apply to S corporations, as compared to partnerships and LLCs. In particular, application of the Social Security and Medicare taxes are more favorable (those taxes generally apply only to amounts paid as wages to the owners for S corporations, but to all income for partnerships and LLCs); computation of capital gain on distributions and sales of interests in the business also differ under the two systems.

Not all pass-through firms are small.

Tax data are typically compiled and reported based on the business form (C corporation, S corporation, and so forth) and many use the data on pass-through firms as a proxy for small business data. Most observers tend to equate C corporations with big business and pass-through entities with small business, because larger businesses tend to operate as C corporations, while most small businesses are taxed on a pass-through basis. But the two categories do not directly correspond with one another. There are many small C corporations; nationally about one-quarter of them had gross receipts of less than $25,000 in 2007. And some big businesses are taxed on a pass-through basis. For example, in 2005 over half of the net income of partnerships nationally was attributed to firms with annual gross receipts over $50 million.

Pass-through and proprietor business income contributes a substantial share of Minnesota's individual income tax revenues.

Data compiled by the Department of Revenue reveal the following:

- Taxing this income (as well as allowing the losses to reduce other income) contributed about 11.3 percent of individual income tax revenues for tax year 2007.
- In tax year 2007, 12 percent of returns reported sole proprietor income, 5.2 percent reported S corporation or partnership income ("pass-through income"), and 16 percent reported either or both types of income.
- About 84 percent of the returns reporting positive pass-through or proprietor business income have total income that is less than the starting point for the current top rate bracket; that is, they are not top-bracket returns.
- Returns with total income sufficient to put them into the top bracket (1) are much more likely to have pass-through business income and (2) report most of the pass-through income. For example, 25 percent of top-bracket returns had positive pass-through business income, compared with 5 percent of all returns, in tax year 2007. These top-bracket returns reported 86 percent of positive pass-through business income. The percentage of returns with positive pass-through income increases at the higher income levels for the new top bracket in the 2009 legislative proposals. For example, 42 percent of the returns in the new top bracket proposed in House File 2323 had positive pass-through business income.

Caution should be used in making tax policy conclusions based on this data.

These caveats or cautions relate both to policies tied to business size and to policies that single out "business income," in particular pass-through income from S corporations or partnerships, for tax treatment different than other types of income (such as wages, interest, and dividends).

- As noted above, much of the income of pass-through entities is not derived from small firms, if the benchmark for "smallness" is gross receipts or net income.
- Most firms that provide professional services (law firms, accounting firms, medical providers, real estate service providers, and so forth) are pass-through entities. Some of the income of these firms represents compensation for the services (labor or work) of their owners, more analogous, perhaps, to wages than traditional business profits. This is also true, but probably to a lesser extent, for firms in other lines of business.
- Some of the reported pass-through income derives from passive investments in these businesses. Income from these types of investments may be more analogous to dividend and interest income than business profits. Some of these investments may, in fact, be made by Minnesota residents in businesses operating primarily or exclusively in other states.

Types of Business Entities and Tax Implications

Various factors affect the choice of the form of business organization.

Business owners can choose among several different forms of organization with different tax and other legal consequences to each of them. They can operate as a:

- Sole proprietor (no explicit or formal business organization);
- Partnership (which can take several different forms, such as a limited partnership or limited liability partnership);
- Limited liability company or LLC;
- S corporation[1]; or
- C corporation.

In choosing the type of organization for their business, owners will balance tradeoffs among simplicity, legal protection, access to capital, taxes, and other factors. The focus of this information brief is on tax issues; however, the box at the right identifies some nontax factors that affect the choice of entity.

Nontax Factors That Affect the Choice of Entity

- **Protection from legal liability.** Corporations, limited liability companies, and some types of partnerships offer more legal protection than sole proprietorships or regular partnerships. A sole proprietor or a general partner is individually liable for any actions or failures of the business. In contrast, the liability of a corporation, limited liability partnership, or LLC is limited to the business assets.
- **Ease of operation.** A sole proprietorship is the simplest business entity, since it requires taking no formal action. Most small businesses don't bother forming an entity and report their income as proprietors. Forming one of the business entities requires registering, electing officers, holding regular meetings, maintaining entity records, and so forth.
- **Access to capital.** Although the choice of entity does not affect access to debt capital (such as bank borrowing or selling bonds), generally a business must be a C corporation for its stock to be traded on a stock exchange.

Different tax requirements apply to each type of entity or organization.

C corporations report and pay tax at the entity level—through the federal corporate income tax and Minnesota corporate franchise tax—while the other businesses' tax is paid at the individual level. Sole proprietorships report and pay income and self-employment tax directly on the owner's individual return. S corporations must file informational business returns and also report income from the business to the shareholders on a separate schedule. The owners then report the income and also pay self-employment tax on wages paid for services they provide to the business at the individual level. Partnerships can elect to be taxed as corporations (called "checking the box"); if they don't elect to be taxed as a corporation, then their income is reported and taxed on their owners' individual income tax returns, with the full amount of income reported subject to self-employment tax. LLCs, like partnerships, can elect to be taxed as

[1] These letter designations of "S" and "C" refer to the subchapter of the Internal Revenue Code that contains the rules for taxing these entities.

corporations; those that do not "check the box" may choose to report either as a partnership or as a sole proprietorship. Generically, S corporations, partnerships, and multimember LLCs that haven't "checked the box" (i.e., LLCs choosing to report as partnerships) are referred to as "pass-through" entities, because their income and its tax consequences are "passed through" to their owners' personal tax returns.

C corporation income is taxed annually at the entity level, but is not taxed at the individual level until it is distributed as dividends or until stock is sold and capital gains realized. Businesses that choose not to pay dividends may retain income for business growth without individual income tax consequences to the owners/shareholders.

The income of S corporations and partnerships (including LLCs reporting as partnerships) is recognized as distributed to the owners/shareholders or partners annually for tax purposes, even if the income is retained within the business. In that situation, the shareholders' pro-rata shares of income are still reported to them and they must pay income tax on the income, even though they never actually received it. This is sometimes referred to as "phantom income." Business owners in this situation adjust their basis in the entity upward by the amount not distributed.[2] This will result in their realizing smaller gains (and paying less tax) if they sell their shares in the entity. In practice, most pass-through entities typically distribute at least enough income to their owners to cover the federal and state tax due on that income.

Table 1 summarizes the tax treatment of the different forms of business.

Table 1

	Sole proprietorship	**S corporation**	**Partnership**	**C corporation**
Social Security and Medicare taxes apply to	Net profit	Compensation of officers, directors, and other employees	Net profit	Compensation of officers, directors, and other employees
Federal and state income tax applies to	Net profit	Net profit plus compensation of officers and directors	Net profit	Compensation of officers and directors and dividends paid
Federal and state corporate tax applies to	N/A	N/A	N/A[3]	Net profit

[2] Pass-through entities and their owners must keep track of two forms of basis (the tax cost that is a key in determining gain, loss, and various other tax calculations). In very simplified terms, "**outside basis**" refers to the owner's (S corporation shareholder, partner, or LLC member's) basis in his or her share of the entity and that determines the owner's gain or loss on disposition of all or part of his or her ownership (e.g., sale of S corporation stock). By contrast, "**inside basis**" is the basis on the books of the entity and will generally determine the gain, loss, and allowable depreciation of the entity (S corporation, LLC, or partnership) for its transactions and activities. The tax attributes that result from the inside basis are, though, ultimately reported to and determine tax on the owners' individual returns.

[3] This assumes that the partnership (or LLC) does not "check the box" and elect to be taxed as a C corporation.

Two major differences in the taxation of the different business entities are:

- the amount of income subject to Social Security and Medicare taxes and
- the effective double taxation of net profits of C corporations.

S corporations pay self-employment tax for Social Security and Medicare only on amounts paid to their shareholder/owners as wages, while sole proprietorships and partnerships pay self-employment tax on their net profit. This is a prime advantage of forming an S corporation, since it allows business owners to minimize their liability for the self-employment tax.[4] A partnership must report and its partners pay self-employment tax on the net business income of the partnership, while an S corporation does so only on the amount paid to employees as wages. If shareholders elect to pay themselves modest wages and treat most of the earnings as business income, much of the self-employment tax is avoided. In some cases, this may be questioned and recategorized by the Internal Revenue Service if the wages paid are not reasonable, relative to the value of the service provided. However, according to some accounts, the Internal Revenue Service typically challenges these arrangements only if owners pay themselves little or no salary.[5]

C corporations, including LLCs and partnerships that "check the box," must pay tax on the business's income twice to use it for personal purposes. C corporations are subject to federal corporate income tax and Minnesota corporate franchise tax on their net profits, and then these profits are taxed again when paid to shareholder/owners as dividends, or when the shareholders sell the stock and realize capital gains. In contrast, net profit of proprietorships and pass-through entities is taxed only once.

This "double" taxation of C corporations creates an incentive for businesses with significant profits to operate as pass-through entities, whenever possible. Publicly traded companies—i.e., corporations whose stock is traded on a stock exchange—generally operate as C corporations. Conventional wisdom is that newly formed businesses opt for direct taxation as a proprietorship or pass-through taxation to avoid this double taxation, unless they plan to "go public" within a short period of time. Businesses typically choose between operating as an S corporation or LLC, taxed as a partnership.

There are other important differences in the taxation of the different types of pass-through entities. Most tax professionals think partnerships have a number of important tax advantages over S corporations, putting aside the differences in Social Security and Medicare taxation. A somewhat more comprehensive (but still very simplified) catalogue of the varying tax treatment of different forms of business entities is provided in Appendix A. However, the fact that more businesses choose to organize as S corporations than as partnerships suggests that the self-employment tax advantages for S corporations may be a deciding factor in the choice of business form.

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[4] C corporations and their employees are subject to FICA taxation on employee wages. This imposes a combined tax burden essentially equal to the tax under the Self-Employment Contribution Act (or SECA) on employees of S corporations.

[5] Walter D. Schwidetzky, "Integrating Subchapters K and S – Just Do It," *Tax Lawyer* 62, no. 3 (Spring 2009): 798–801 (discussing cases).

Table 2 compares the amount of tax paid by a business with $100,000 of net profit ($80,000 of which is really compensation for services provided by the owners or officers) for different business entities.

Table 2

	Sole proprietorship	**S corporation**	**Partnership**	**C corporation**
Net profit	$100,000	$20,000	$100,000	$20,000
Compensation of officers		$80,000		$80,000
Self-employment or FICA tax	$14,130	$12,240	$14,130	$12,240
Federal and MN income tax on wages/distributed profits*	$32,050	$32,050	$32,050	$25,640
Federal and MN corporate tax	N/A	N/A	N/A	$4,960
Tax on C corporation dividend to shareholder**	N/A	N/A	N/A	$4,410
Total tax liability	$46,180	$44,290	$46,180	$47,250

* Assumes federal rate of 25% and Minnesota rate of 7.05%.
** Assumes 15% federal rate and 7.05% Minnesota rate.

For the S and C corporations, $80,000 of the net profit is assumed to be paid to the owners/shareholders as wages, with the remaining $20,000 reported as business income. The S and C corporations pay less in payroll taxes than do the partnership or sole proprietorship, since payroll taxes only apply to the $80,000 paid the owners in wages. The owners of the sole proprietorship and the two pass-through businesses pay state and federal income tax on the full $100,000, regardless of whether it is paid as compensation to the officers and reported as wages or flows through and reported as business income. The owners of the C corporation are subject to payroll taxes only on the $80,000 of wages, like the S corporation. In addition, the remaining $20,000 of net profit is subject to federal corporate income tax and Minnesota corporate franchise tax of $4,960. Table 2 assumes this $20,000 is paid to the owners as dividends, subjecting it to additional federal and state income tax of $4,410. This is the “double taxation” of corporate profits that makes organizing a business as a proprietorship or pass-through entity attractive from a tax perspective.

Appendix B provides tax calculations for a two-owner S corporation, including the effects for S corporation shareholders of basis adjustments from pass-through income.

National and State Data on Business Type and Size

Proprietor and pass-through entities are often used as a proxy for "small businesses" but tax data reveal many of them are not small.

Table 3 lists the number of business filing tax returns by organizational form. Most business owners—72 percent nationally and 66 percent in Minnesota—report their income as proprietors rather than bothering to form a business entity. Although most advisors consider LLCs, electing to be taxed as a partnership or proprietorship, to be the entity of choice, most business owners who choose to form a business entity elect S corporation treatment.[6] One likely explanation for the continued popularity of S corporations is the favorable treatment of S corporation profits under the Social Security and Medicare taxes, as compared with partnerships and LLCs. The number of C corporations is gradually declining both nationally and in Minnesota.[7] This likely reflects the tax disfavored status of these entities, as described above. Research suggests that reduction of the top individual income tax rate to a level at or below the corporate rate was a pivotal factor in this decline.[8]

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[6] The LLC form provides its owners with the liability protection of a corporation, while partnership taxation is more flexible than S corporation taxation. *See, e.g.,* Schwidetzky, "Integrating Subchapters," 749, 759 ("[L]imited liability companies (LLCs), which are usually taxed as partnerships, in most contexts make S corporations obsolete." "Most tax professionals will affirm that on balance a partnership is, from a federal income tax perspective, superior to an S corporation."). This gap has, however, been closing. The Minnesota growth rate for partnerships between 2000 and 2008 was 9.4 percent, while the number of S corporations grew by 6.6 percent over the same period. If this pattern continues, partnerships (mainly LLCs taxed as partnerships) will ultimately displace S corporations as the most popular business entity.

[7] In tax year 1986, 2.6 million C corporations filed federal returns (or about 14.9 percent of all business filing returns). For tax year 2007, that number had declined to 1.9 million filings (or about 5.9 percent of all business filings). Partnerships (including LLCs) and S corporations experienced a dramatic rise in filings over the same period, increasing from 2.5 million to 7.1 million. Statistics of Income, Internal Revenue Service, Integrated Business Data, accessed October 4, 2010, http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html. Minnesota filings of C corporations in 1986 were 53,226. By 2005 (the last year for which data is available), these filings had declined to 47,990 (or an 11 percent drop). Minnesota Department of Revenue, *2005 Minnesota Corporate Income Tax Bulletin* (November 2009): 6, accessed October 4, 2010, http://taxes.state.mn.us/legal_policy/Documents/other_supporting_content_corp_bul_05_links.pdf; Minnesota Department of Revenue, "Corporation Income Tax Returns Filed During Calendar Year 1986," *Income Tax Bulletin* no. 67 (April 1988): 7.

[8] Prior to the 1986 tax reform, the top federal individual rate was four percentage points higher than the top rate applicable to C corporations. This provided a slight rate advantage for C corporation status for a business planning to retain its earnings. Following the 1986 tax reform, the top individual rate was six percentage points lower than the top corporate rate. Thus, tax reform eliminated that rate advantage. After a series of changes in the 1990s and in 2001, the two top federal rates are now identical (at 35 percent for tax year 2010). Economists have concluded that the reversal of the top rates was an important factor in the growth of pass-through entities. Alan Auerbach and Joel Slemrod, "The Economic Effects of the Tax Reform Act of 1986," *Journal of Economic Literature* 35, no. 2 (1997): 589–693.

Table 3

Number of Businesses by Type
Tax Year 2007
(amounts in 000)

Business type	National	% of total	Minnesota	% of total
Sole proprietors (nonfarm)	23,127	72.1%	380	65.5%
S corporations	3,990	12.4%	96	16.5%
Partnerships (including LLCs)	3,096	9.7%	57	9.8%
C corporations	1,865	5.8%	47	8.2%
Total	32,078		580	

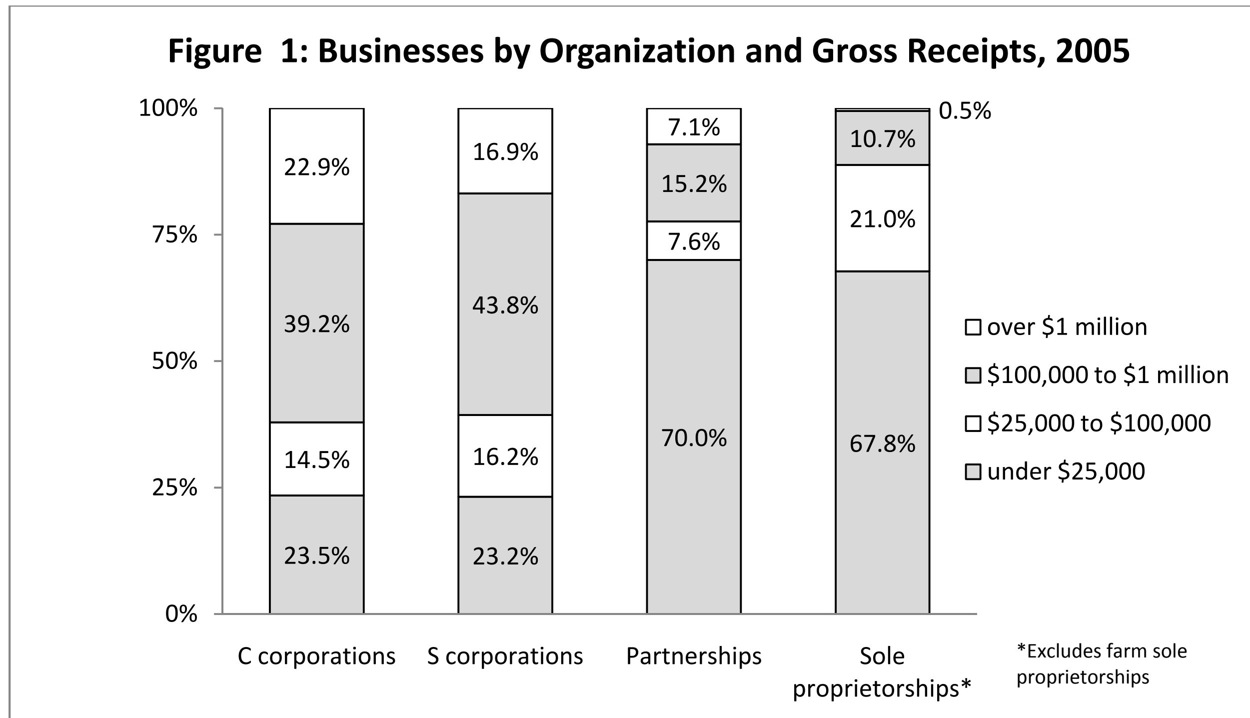
Source: Statistics of Income, Internal Revenue Service (national); Minnesota Department of Revenue (Minnesota)

Businesses report income and pay taxes as a function of how they are organized, not their size, and most tax data similarly are compiled based on the type of business organization. While the term "small business" is used frequently in policy discussions and in the media, there is no agreement on a single definition of "small business" for tax purposes.[9] Most people likely think that whether a business is "small" depends upon how many employees, assets, sales, or profits it has, not its form of organization. However, because most tax data are presented by organization type and because virtually all publicly held companies are C corporations, many naturally assume that sole proprietors and pass-through entities are "small businesses." National tax data reveal that this generalization or assumption can be misleading.

There are very big S corporations and very small C corporations. Figure 1 shows the distribution of nonfarm businesses by organization and amount of gross receipts for 2005 based on national data.[10]

[9] Gary Geunther, "Small Business Tax Benefits: Overview and Economic Rationales," Congressional Research Service (revised March 3, 2008): 3, fn. 4, , cites a source that the Internal Revenue Code contains "at least 24 different definitions of a small business"; accessed June 11, 2010, http://file.wikileaks.org/file/crs/RL32254.pdf.

[10] Statistics of Income, Internal Revenue Service, from "Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity," Joint Committee on Taxation, JCX-48-08, June 4, 2008.



C corporations are most likely to have gross receipts over $1 million (22.9 percent); but a large share of S corporations (16.9 percent) also have gross receipts over $1 million. Large businesses tend to be C corporations; in 2007 about 6 percent of all tax-filing businesses were C corporations, but C corporations collected 62 percent of business gross receipts.[11] A substantial fraction—nearly a quarter—of C corporations had gross receipts under $25,000. Both sole proprietorships and partnerships are more likely to have low levels of gross receipts. All this suggests caution in thinking that all C corporations are "big" businesses and that all S corporations and partnerships are "small" businesses. Moreover, a small number of pass-through entities earn most of the aggregate net income of these businesses. For example, in 2005 over 57 percent of the net income of all partnerships in aggregate was attributable to firms with annual gross receipts exceeding $50 million.[12] Similarly, less than 1 percent of partnerships in 2008 had assets in excess in $100 million, but these partnerships earned over 53 percent of the aggregate net income of all partnerships.[13] There are some highly publicized "big" S corporations and partnerships. For example, the Tribune Company, a large media company that owns 23 television stations and 12 newspapers, including the Chicago Tribune, Los Angeles Times, and Baltimore Sun, and the Chicago Cubs baseball team, was formerly a publicly traded C

[11] Statistics of Income, Internal Revenue Service, "Table 3.--Number of Businesses, Business Receipts, Net Income, and Deficit, by Form of Business and Industry, Tax Year 2007," accessed September 14, 2010, http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html.

[12] Ibid., Table 8a, p. 20.

[13] Statistics of Income, Internal Revenue Services, Partnership Tax Statistics, accessed September 3, 2010, http://www.irs.gov/taxstats/bustaxstats/article/0,,id=130919,00.html.

corporation, but converted to a privately held S corporation in 2007 in a total deal valued at about $13 billion ($8.2 billion in equity).[14]

Minnesota Tax Data on Businesses Subject to Pass-through Taxation

In brief, this data show for tax year 2007 that filers with business income are distributed widely across the entire income distribution, but that business income, particularly from pass-through sources, is concentrated on top bracket returns:

- Business income contributed about 11.3 percent of Minnesota individual income tax revenues.
- About 16 percent of all Minnesota filers (or 360,000 returns) reported positive business income as either proprietors or from pass-through sources (S corporations, partnerships, or LLCs).
- Top bracket returns were much more likely to report some type of business income—about 25 percent of returns versus 13 percent for the rest of the filer population.
- Only about 16 percent of the returns with positive business income had enough total taxable income to be in the top bracket, but these returns reported over 86 percent of pass-through income and over 32 percent of proprietor income.

The Department of Revenue (DOR) has compiled data from tax returns reporting proprietorship and pass-through business income. DOR initially compiled this data during the 2009 legislative session from tax year 2006 returns to help evaluate the impact of legislative proposals to impose new top rates of 9 percent (House File 2323) or 9.25 percent (Senate File 2074). (Neither of these proposals was enacted into law.) A primary goal was to assess how much proprietor and pass-through business income would be subject to tax at the new proposed top rates.[15] DOR has now updated this data to reflect tax year 2007 returns. The data detail the distribution of tax returns and sole proprietor, S corporation, and partnership income by income tax bracket, including the two proposed top rate brackets. The data are for full-year Minnesota resident returns filed by taxpayers who were not claimed as dependents on other returns.[16]

[14] Allan Sloan, "Tribune Deal Makes Zell Ace of Tax Dodgers," *Washington Post* (May 1, 2007), accessed October 26, 2010, http://www.washingtonpost.com/wp-dyn/content/article/2007/04/30/AR2007043001553.html.

[15] House File 2323 proposed a new 9 percent rate that would have applied at $300,000 of taxable income for married joint filers, $169,700 for single filers, and $255,560 for heads of household. Senate File 2074 proposed a new 9.25 percent rate that would have applied at $250,000 of taxable income for married joint filers, $141,250 for single filers, and $212,500 for heads of household. Neither bill included a corresponding increase in the current alternative minimum tax rate of 6.4 percent (which is the rate under the current law). The original analysis using 2006 data and the updated analysis using 2007 data both deflated the proposed 2009 brackets to the equivalent amounts in 2006 and 2007 dollars, respectively.

[16] Note that this excludes the out-of-state investors in (or less frequently operators of) Minnesota businesses. Including these returns would present complications and could create confusion because these individuals typically derive most of their income from non-Minnesota sources and often are high-income returns. As a result, they were

This part of the information brief uses this DOR data to report how much tax is attributable to proprietor and pass-through income and, secondly, to present the share of pass-through income that is reported by filers, some of whose total income is taxed in the various top tax brackets (under current law or the 2009 legislative proposals). It should be noted that a fair number of returns with proprietor or pass-through business income report net losses or negative business income. For these taxpayers, including their proprietor or pass-through income actually reduces their tax liability. With the exception of the section addressing the effect of business income on income tax revenues, returns with net losses are excluded from the data displayed in this section, since it is difficult to say (at least for the current year) that this business "income" is subject to tax. However, Appendix C displays comparable data for all returns with proprietor or pass-through income or losses. See the box below for some caveats regarding using this data.

Caveats on Interpreting the Data

Legislators interested in business taxation should use caution in assessing the policy implications of tax return data on proprietorship and pass-through entities. Two caveats are worth noting:

- Tax return data makes it difficult to distinguish between income from capital (profits) and labor (the compensation of the owners for services they provide)
- Some reported income of pass-through entities reflects passive investments of their owners

Capital vs. Labor Income. Business owners often both invest their capital (savings and borrowings) and provide services to (work for) the business. Differences between capital and labor income are important conceptually to economists and policymakers.* But businesses probably don't distinguish between the two types of income, unless doing so is important for tax or personal finance reasons.

Tax reporting confuses matters by requiring different reporting from different types of entities:

- Partnerships (including most LLCs) and proprietorships report all of their income as a single amount, whether this is a return on capital or compensation for their partners' labor.
- S corporations, by contrast, separately report compensation to their owners. But tax rules encourage understating these amounts to reduce Social Security and Medicare taxes.
- Partnership and S corporation income are reported on the same line of Schedule E, making it impossible to distinguish between the two.

Passive Income. Tax return data do allow distinguishing between passive income (which is reported separately for purposes of the passive loss limitation rules) and income of owners who materially participate in the business. But it is unclear how reliable that distinction is, particularly for businesses reporting positive income where the tax consequences are minor and likely are rarely subject to auditing. This may be important for legislators who wish to provide incentives only to investors who materially participate in the business. It is also worth noting that some pass-through income is from investments (active or passive) by Minnesota residents in businesses operating outside of Minnesota.

* For example, the Governor's 21st Century Tax Reform Commission proposed preferential treatment for business income to make Minnesota more competitive in attracting business investment. The proposal was limited to pass-through income.

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excluded. As noted in the data caveats box, however, the reported data does include out-of-state business interests of Minnesota residents.

Table 4 shows the income breakpoints[17] by filing status for the three income tax brackets for tax year 2007. Income breakpoints for married filing separate returns are one-half the amounts shown for married joint filers.

Table 4

Income tax brackets, tax year 2007			
	Married filing joint	Single	Head of household
5.35 percent	$0 to $31,150	$0 to $21,310	$0 to $26,230
7.05 percent	$31,151 to $123,750	$21,311 to $69,990	$26,231 to $105,410
7.85 percent	Over $123,750	Over $69,990	Over $105,410

Minnesota's individual income tax revenues in 2007 would have decreased by about $805 million, or 11.3 percent of total income tax revenues, if all proprietor and pass-through business income (and losses) had been excluded from Minnesota's income tax.

The income tax paid on proprietor and pass-through business income can be calculated in different ways; there isn't a straightforward or "right" answer as to how to make this calculation. In particular, the tax paid can be calculated on a marginal basis (how much more tax is paid because the pass-through income is added to each taxpayer's income) or on an average basis (assuming this income pays tax at the average tax rate paid either by that taxpayer or by all taxpayers). The graduated rate structure and various limitations on deductions, subtractions, and exemptions (and the allowance of these against all types of income) typically will result in the marginal calculation yielding larger numbers than calculating the tax burden on an average basis. The Department of Revenue calculated the tax paid under both methods.

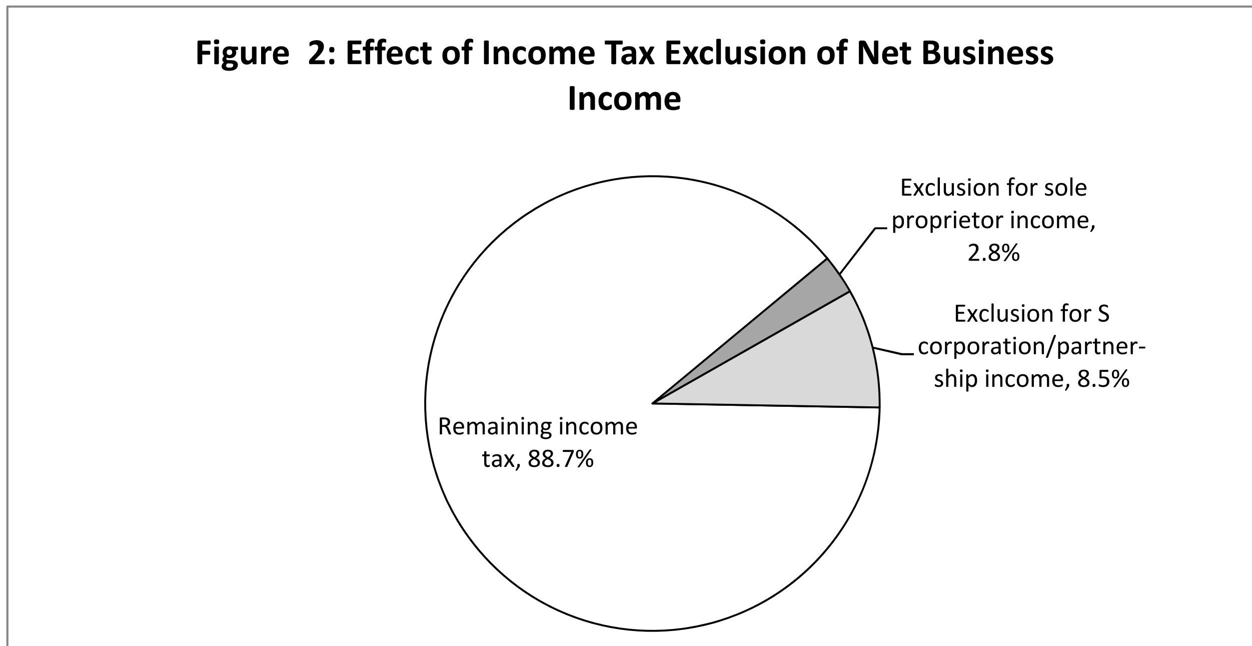
- Following the marginal calculation approach, the Department of Revenue calculated that taxes would have decreased by $198 million if all sole proprietor income of Minnesota resident returns had been excluded from Minnesota income taxation, and by $607 million if all S corporation/partnership income had been excluded. Combined, this represents 11.3 percent of 2007 income tax revenues.[18]
- An average tax rate calculation yielded a slightly lower amount of tax. This alternative calculation divided total state liability by federal adjusted gross income, arriving at an overall average tax rate on federal adjusted gross income (FAGI) of 3.8 percent for sole proprietor income and 6.8 percent for S corporation/partnership income. Applying those rates to the $4.1 billion of sole proprietor income and the $8.6 billion of net S corporation/partnership income reported in 2007 results in tax of $155 million on sole proprietor income and $581 million on S corporation/partnership income for a total of

[17] The income measure used is Minnesota taxable income for married joint filers. This income measure is adjusted gross income after all deductions and exemptions, including the standard deduction or itemized deductions, and after all Minnesota additions to and subtractions from taxable income.

[18] This estimate is of the change in tax after all credits and excludes any secondary effects that the exclusion of pass-through income may have on computation of refundable state income tax credits.

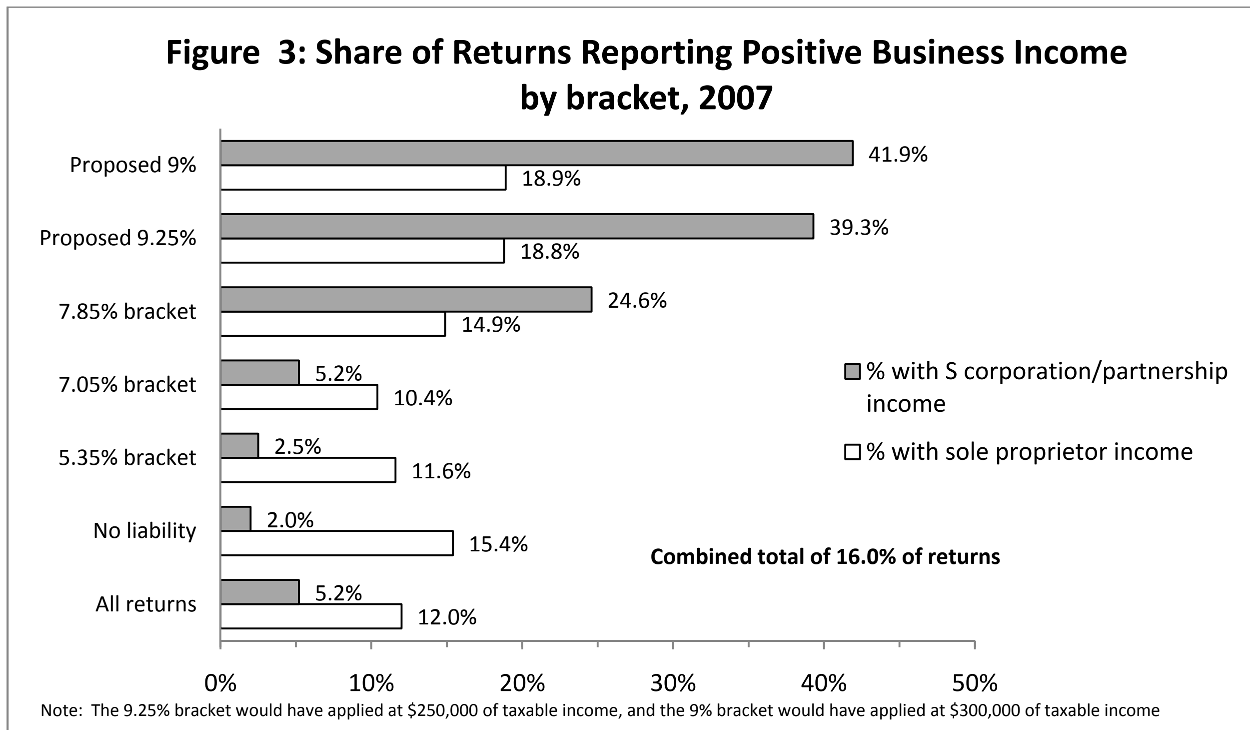
$736 million, less than the $805 million resulting from estimating the effect of excluding all proprietor and pass-through business income.[19]

Figure 2 shows the effect of proprietor and pass-through business exclusion on overall Minnesota income tax revenues using the marginal calculation approach.



[19] The method of excluding pass-through income from the income tax base results in a larger estimate than the average tax rate method because it assumes that the pass-through income is subject to the highest tax rate faced by the taxpayer, to the extent the taxpayer's top-bracket income equals or exceeds the total amount of pass-through income. The average tax rate, in contrast, assumes that the pass-through income is taxed at the average rate, determined by dividing taxable income by tax liability. For example, a married couple in 2007 with $500,000 of taxable income, of which $100,000 was pass-through income, would realize a tax reduction of $7,850 if pass-through income were excluded from Minnesota's income tax ($100,000 of pass-through income, times 7.85 percent). The total tax paid on their $500,000 of taxable income is $37,730 (5.35% of the first $31,150, 7.05% of the amount from $31,150 to $123,750, and 7.85% of all over $123,750), for an average tax rate of 7.55 percent. Applying the average rate to the $100,000 of pass-through income results in a tax benefit of $7,550, lower than the $7,850 benefit that results from simply excluding the pass-through income from tax.

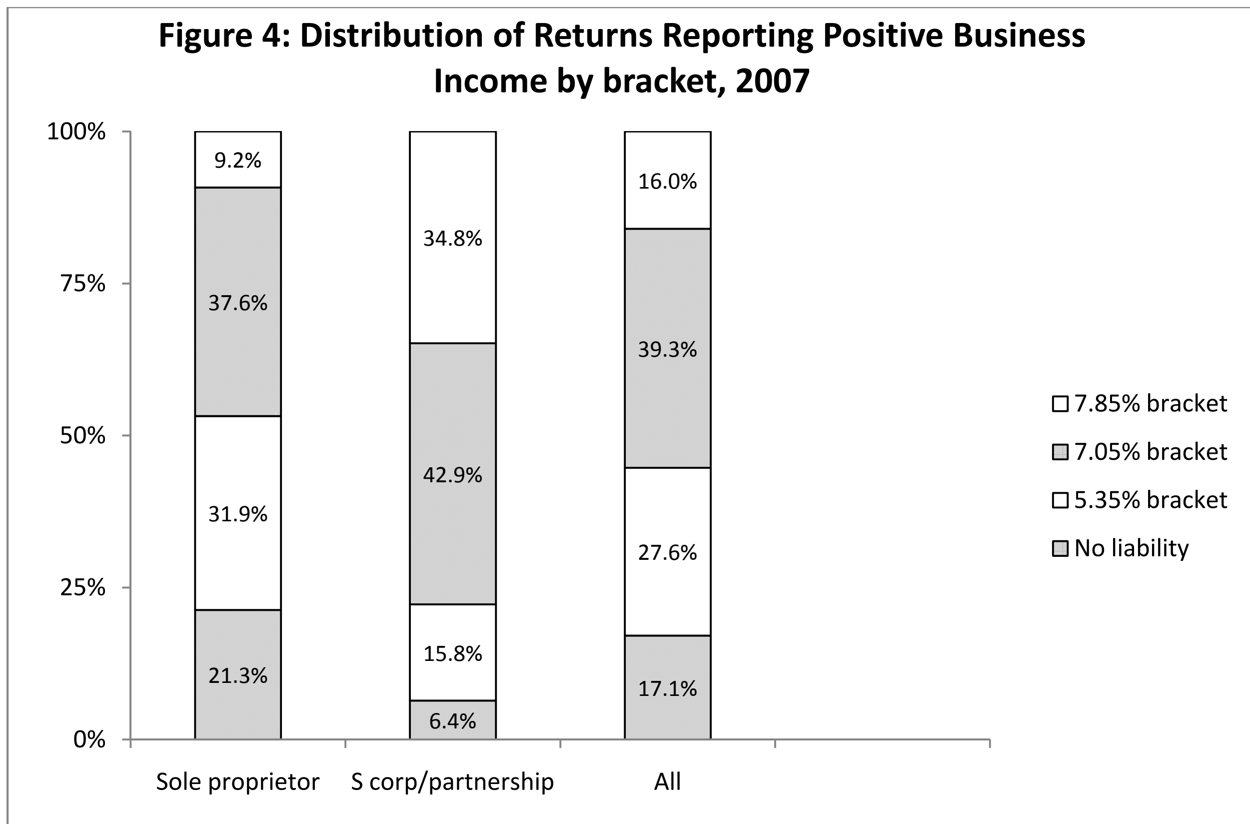
In 2007, 12.0 percent of the roughly 2.2 million Minnesota resident income tax returns included Schedule C and reported positive sole proprietor income,[20] and another 5.2 percent included Schedule E and reported positive S corporation or partnership income.[21] Returns in the top bracket and those with no liability were more likely to report positive business income than were those in the middle and bottom brackets. As an example, 24.6 percent of returns in the 7.85 percent bracket reported S corporation or partnership income, and 14.9 percent of returns in that bracket reported sole proprietor income. Returns in the proposed 9 percent and 9.25 percent brackets were even more likely to report positive business income—41.9 percent of returns in the proposed 9 percent bracket, set at taxable income over $300,000 for married joint filers, reported positive S corporation or partnership income. Note that some returns reported both sole proprietor and S corporation/partnership income, so that the percentages in Figure 3 aren't strictly additive. While 12.0 percent of returns reported Schedule C income and 5.2 percent S corporation/partnership income, 1.2 percent reported both kinds of income, so the total share of returns reporting either form of business income was 16.0 percent.



[20] Schedule C returns include single-owner LLCs that elect to disregard corporate status for tax purposes and report as sole proprietors.

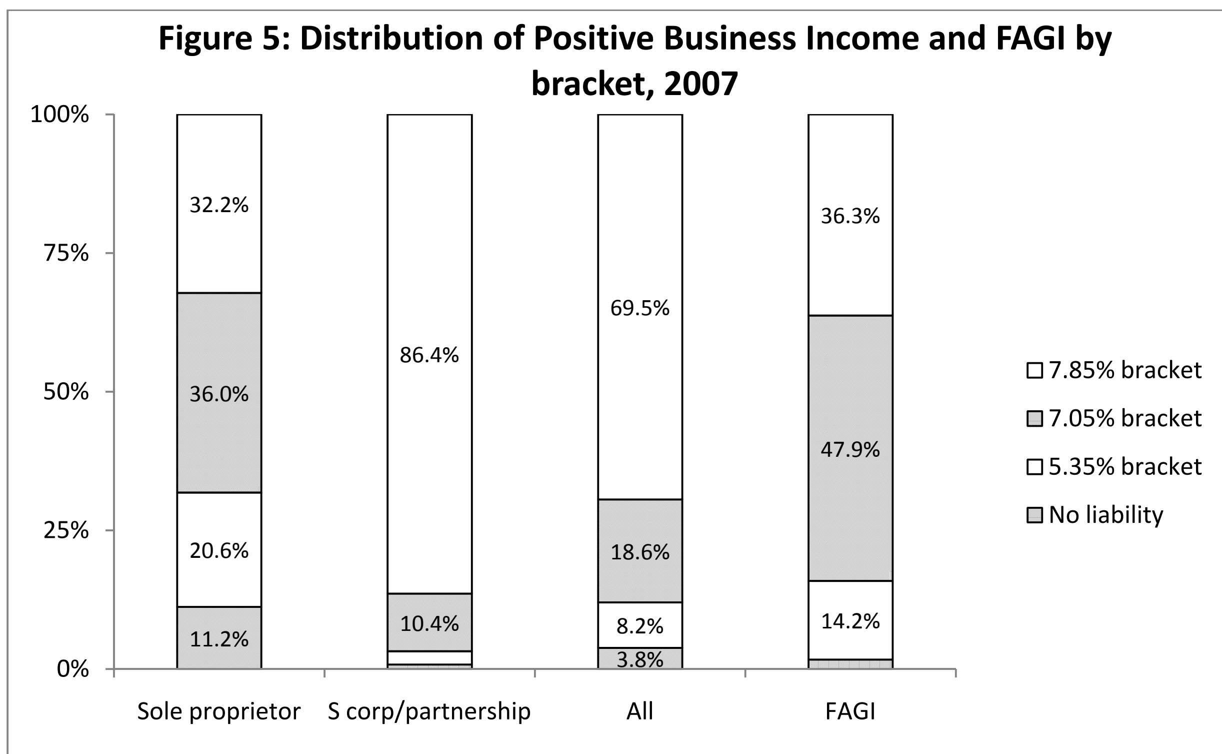
[21] Schedule E reports income items for S corporations and partnership on the same line, so data relating to these two business forms cannot be disaggregated. In addition, S corporation and partnership data includes multiple owner LLCs that elect to disregard corporate status for tax purposes and report as partnerships.

Of all returns with positive proprietor or pass-through income, only 16 percent had income in the top income tax bracket. Figure 4 shows that S corporation and partnership returns were more heavily concentrated in the top bracket (34.8 percent) than were sole proprietor returns (9.2 percent). There were many more sole proprietor returns than pass-through returns—over 268,000 compared with about 117,000—which pulled the overall share in the top bracket closer to the share reported for sole proprietor than to that reported for returns with pass-through income. Close to 40 percent of returns with both types of business income were in the 7.05 percent bracket. Over half of all proprietor returns were in the bottom bracket or had no liability, compared with just over 20 percent of S corporation/partnership returns.



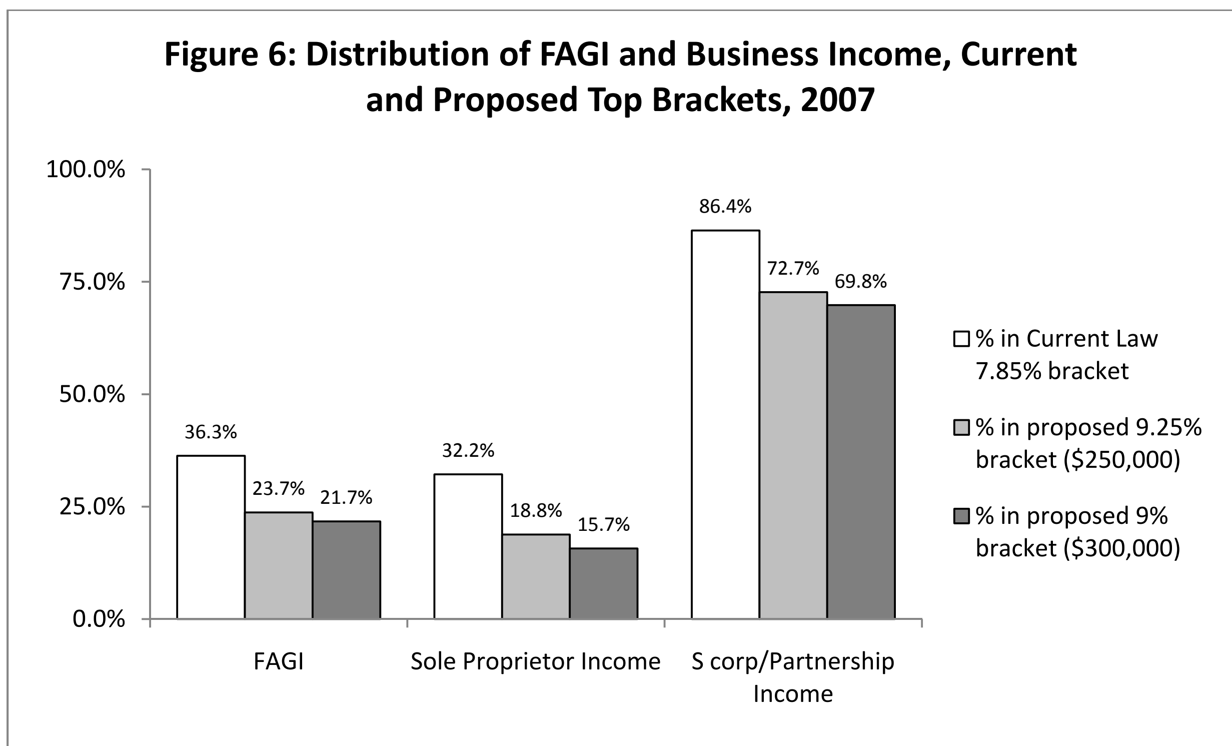
Positive proprietor and pass-through business income reported on 2007 Minnesota individual income tax returns was more heavily concentrated in returns paying some tax at the top and middle bracket rates than was overall federal adjusted gross income (FAGI). For tax year 2007, about $12.7 billion of proprietor and pass-through income was reported on returns by Minnesota residents ($4.1 billion by proprietors and $8.6 billion by S corporations and partnerships).

Figure 5 compares the distribution of proprietor and pass-through income by bracket; the percentages for each income type sum to 100 percent across all brackets. About 86 percent of S corporation and partnership income was on returns with income in the 7.85 percent bracket, although the 7.85 percent bracket had only 36.3 percent of FAGI from all sources. Returns with no liability reported only 11.2 percent of the total sole proprietor income in 2007, despite the fact that 21.3 percent of those returns had at least some sole proprietor income. Similarly, the 6.4 percent of no liability returns with positive S corporation/partnership income reported net S corporation/partnership income equal to only 0.8 percent of all net S corporation/partnership income for the year. Sole proprietor income was more common on the lower end of the income distribution. Returns with no liability and returns in the 5.35 percent bracket had higher shares of total sole proprietor income than they did of overall FAGI.[22]



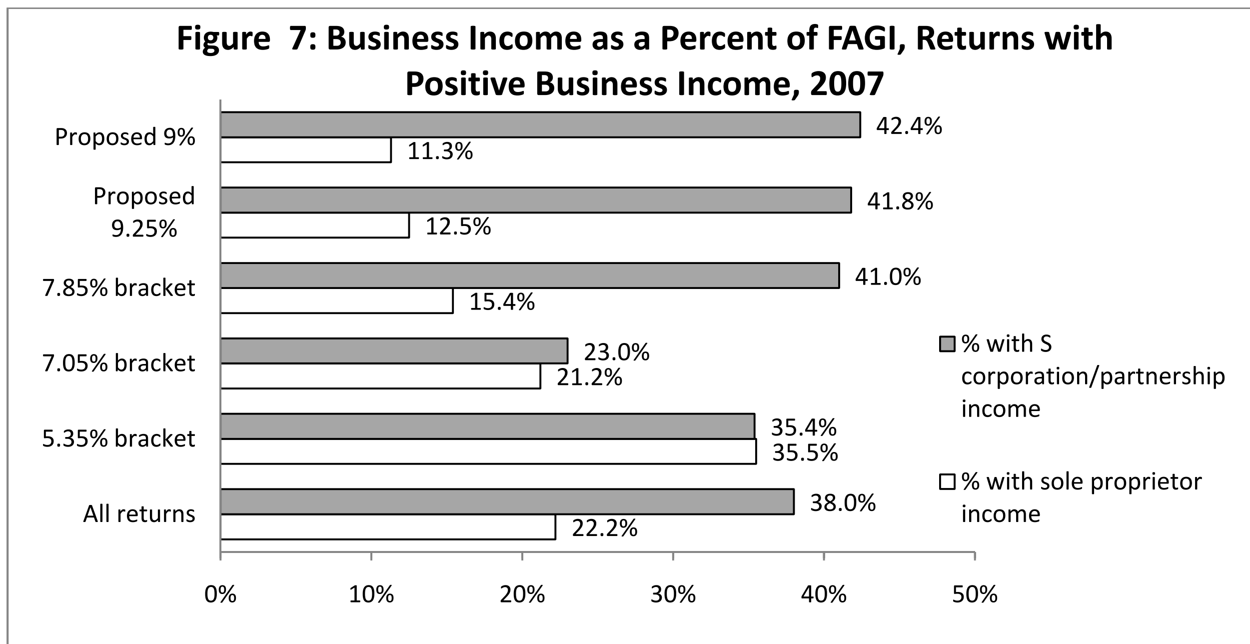
[22] Note that the distribution of FAGI shown in this figure includes returns with negative overall income, while the distribution of sole proprietor income and S corporation/partnership income include only returns with positive business income.

Figure 6 shows the share of top bracket FAGI, sole proprietor income, and pass-through income from S corporations and partnerships that would be in the 9 percent and 9.25 percent brackets proposed in 2009. About four-fifths of the positive S corporation/partnership income in the current law 7.85 percent bracket is on returns that would be subject to the new top brackets; 72.7 percent of S corporation/partnership income was on returns reporting taxable income above $250,000, and 69.8 percent on returns reporting taxable income over $300,000.[23] Sole proprietorship income would be less concentrated in the new top brackets, with almost 60 percent of the 7.85 percent bracket total reported by households with income over $250,000, and slightly under half of the 7.85 percent bracket total reported by households with income over $300,000. FAGI is more concentrated in the proposed top brackets than is sole proprietor income, but less concentrated than S corporation/partnership income



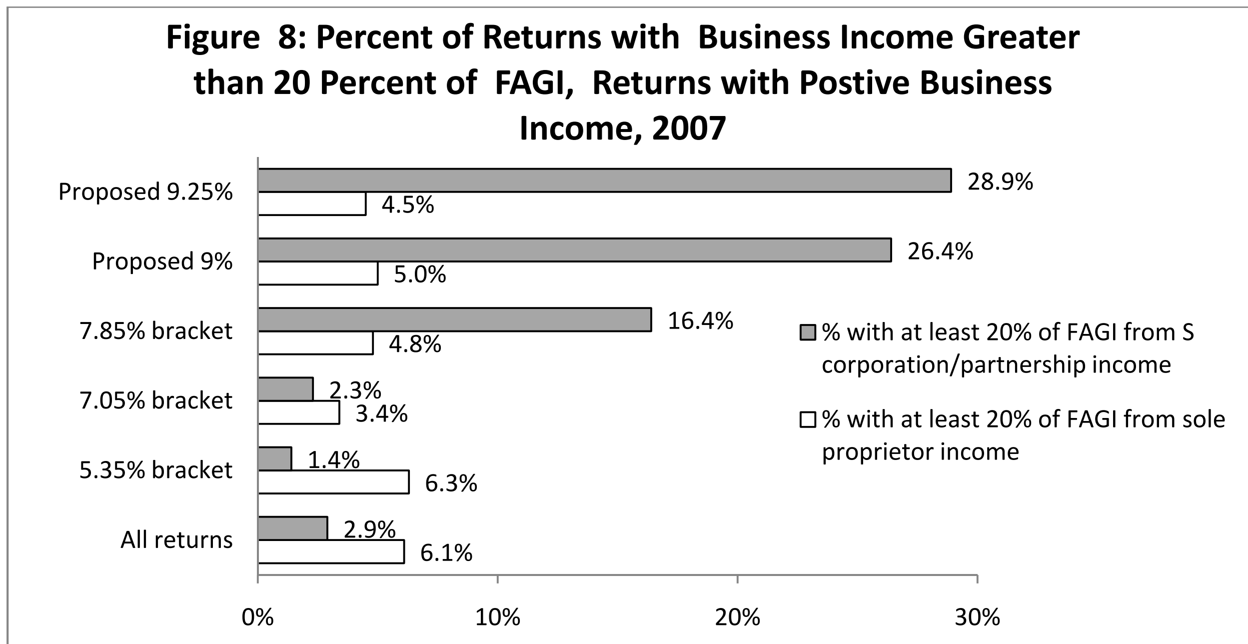
[23] These income levels are for married joint filers; they would be proportionately lower for other filing statuses, as detailed in footnote 15.

Positive S corporation/partnership income made up 38.0 percent of FAGI reported on returns reporting S corporation/partnership income, and positive sole proprietorship income made up 22.2 percent of FAGI on returns reporting Schedule C income or losses.[24] While some returns in all brackets may derive most of their income from business operations, Figure 7 shows that proprietor and pass-through income represents less than half of total income for most returns with that kind of income. S corporation and partnership income is a more important component of FAGI for higher-income returns than for lower income returns. Figure 7 shows that it makes up over 40 percent of FAGI for returns in the top bracket, and also for those in the proposed 9.25 percent and 9 percent brackets. Sole proprietor income, in contrast, makes up a bigger share of FAGI for bottom bracket returns (35.5 percent) than for top bracket returns (15.4 percent).



[24] The data presented in Figures 7 and 8 excludes returns that have negative proprietor and pass-through income from all sources combined (Schedules C, E, and F). This approach will result in somewhat higher percentages than if returns with losses were included and may overstate the role of pass-through income as a component of overall income. The alternative approach, of including returns with negative proprietor and pass-through income, would result in lower percentages and would run the risk of understating the relative role of proprietor and pass-through income.

Top bracket returns were most likely to report S corporation/partnership income as a significant source of FAGI. Figure 8 shows that 16.4 percent of top bracket returns with S corporation partnership income reported that S corporation/partnership income was over 20 percent of FAGI. Sole proprietor income was slightly more likely to make up 20 percent or more of FAGI for bottom bracket returns with sole proprietor income (6.3 percent) than for top bracket returns (4.8 percent). S corporation/partnership income is most likely to be a significant component of FAGI for high-income returns. Over a quarter (26.4 percent) of returns in the proposed 9.25 percent bracket, and 28.9 percent of returns in the proposed 9 percent bracket relied on S corporation/partnership income for over 20 percent of their total income.



Only 2.9 percent of returns with positive S corporation/partnership income and 6.1 percent of returns with positive sole proprietor income derived more than 20 percent of their FAGI from pass-through business income. Statewide, this represented about 125,000 sole proprietor returns and about 60,000 returns reporting S corporation/partnership income. This suggests that many individuals operating businesses do so to supplement income from other sources[25] or may be investors rather active operators of the businesses. National data indicate that about one-third of returns with S corporation or partnership income are reporting income from passive sources, rather than the operation of active businesses by the filers.[26] Passive income is a little less than 20 percent of total S corporation and partnership income.[27]

[25] This is more strictly true with regard to sole proprietorships than S corporations, since the owner/shareholders in S corporations also typically receive wage income from the business. Many S corporations, however, are thought to limit wages paid to owners to minimize Social Security and Medicare taxation.

[26] Jane G. Gravelle, "Small Business and the Expiration of the 2001 Tax Rate Reductions: Economic Issues," Congressional Research Service (September 3, 2010): 4, fn. 5.

[27] Ibid.

Two factors may help explain the concentration of pass-through income from S corporations or partnerships on returns of top bracket filers:

- **Some share of the reported pass-through business income represents return on passive investment.** Policymakers tend to think of taxpayers with business income as entrepreneurs or actual managers or operators of the businesses. However, based on national data, a little less than 20 percent of income represents return on passive investments.[28] These investments are often made by affluent individuals who have large and diverse portfolios that can sustain the risk of direct investments in businesses.[29] (This income is somewhat analogous to dividends and capital gains income of more typical investors who buy publicly traded stocks and bonds.) This effect likely helps explain some of the concentration of this income in upper income households.

- **A portion of this income represents compensation for services provided to businesses, rather than profits.** Most organizations that provide professional services (law firms, accounting firms, medical practitioners, realtors, and so forth) are organized as pass-through entities. According to Internal Revenue Service data, about 95 percent of the firms (with 84 percent of the net income) that provide most professional and real estate services pay tax on a pass-through basis.[30] For partnerships and LLCs (and to a slightly lesser extent S corporations), all of this income is reported as pass-through business income. However, much of this income represents compensation for services provided by the professionals who both own the business and provide services themselves, rather than what most would think of as business income or profits. Because these professionals tend to be high-income earners on average, this situation both leads to the concentration of this income on top bracket returns and may distort somewhat the extent to which this data represents what many think of as more traditional business income or profits.

Note: Both of these factors, perhaps, should give policymakers reason to exercise caution in drawing conclusions about the impact of tax policy changes on the income of businesses and in considering policy proposals designed to provide special tax treatment for "small business income" that are based on the use of pass-through business income. In some cases, this treatment will apply to passive investors and/or compensation for services provided by professionals and similar occupations, which may not be the intent. In other cases, it will apply to income from businesses operating in other states. The data reported in this information brief include, as noted in the data caveats box on page 12, income from businesses that operate in other states. Minnesota residents must report and pay tax on their total incomes, including income from partnerships and S corporations that operate partially or exclusively in other states. Because of constitutional restrictions, special tax treatment for pass-through income (e.g., an exclusion of a portion of the income as proposed by the Governor's 21st Century Tax Reform Commission) would likely need to also apply to this non-Minnesota income.

[28] Ibid.

[29] Another large group of these investors likely are family and friends, whom entrepreneurs tap for investments but who may not have large portfolios or be as affluent as unrelated investors.

[30] For the industry detail, see Appendix C.

Appendix A: Comparative Tax Treatment of Different Entities

Tax Treatment of Different Types of Business Entities or Forms				
Feature	**C Corporation**	**S Corporation**	**Partnership***	**Proprietorship**
Entity level tax (i.e., two levels of taxation, both to entity and individual owner?)	Yes – income taxed to entity under corporate tax and again to shareholder when distributed (as dividends) or realized (as capital gain on sale or exchange of stock)	No, except in limited situations involving S corporations that previously were C corporations and carried over income items	No	No
Maximum number of owners	No limit	100 shareholders	No limit	Not applicable
Classes of equity interests	No limit	One class of stock	No limit	Not applicable
Taxability of transfers of property to entity	Tax-free, if transferees control (80%) the corporation	Tax-free, if transferees control (80%) the corporation	Tax-free (basis carries over for appreciated property)	Not applicable
Allocation of income and losses	Not applicable	Based on shareholder's percentage of stockholdings	As provided in partnership agreement, but must have substantial economic effect	Not applicable
Deductibility of losses by owner	Not applicable	Losses limited to basis in stock and shareholder debt (S corporation debt does not increase shareholder basis)	Losses limited to basis in partnership, including the partner's share of the partnership debt	Yes
Taxability of distributions of property	Taxable as dividend to recipient to the extent of earnings and profits	Gain taxed to corporation (allocated to shareholders) and fair market value basis to shareholder-recipient	Generally tax-free with carryover basis to the partner	Not applicable
Social Security and Medicare tax	Corporation pays employer tax on wages paid	Corporation pays employer tax on wages paid, but no tax on business income	All business income is subject to full taxation	All business income is subject to full taxation

*Includes multimember LLCs that have not "checked the box" and elected to be taxed as C corporations.

Appendix B: Tax Calculations for an Example Pass-through Taxpayer

S corporation, two shareholders, distributes income to shareholders

Taxpayers B1 and B2 formed an S corporation, using $100,000 of money they saved to start a business. B1 contributed 75 percent of the money, $75,000, and owns 75 of the 100 shares of stock. Taxpayer B2 contributed $25,000, and owns 25 of the 100 shares of stock. Both work full-time for the S corporation. They rent a storefront and sell widgets.

The S corporation must file form 1120S, the U.S. Income Tax Return for an S Corporation. The table shows the items reported for this simple example business on form 1120S.

Table B-1

Gross receipts	$225,000
Cost of goods sold	$100,000
Gross profit	$125,000
Total income	$125,000
Deductions	
Compensation of officer B1	$40,000
Compensation of officer B2	$40,000
Rents	$15,000
Taxes (payroll for officers)	$6,120
Advertising	$2,000
Total deductions	$103,120
Ordinary business income	$21,880

The $40,000 of compensation paid to the two officer/owners of the S corporation is subject to payroll taxes. The S corporation itself pays the employer share, totaling $6,120, and each of the two officers pays the employee share, $3,060 each, which the corporation withholds from their compensation. The S corporation itself does not pay any tax on its profits or ordinary business income, but rather the income is allocated to the two shareholders for tax purposes. (As noted later, it doesn't matter for tax purposes whether the corporation actually distributes or retains these profits to its shareholders). The business income is reported on Schedule K, a supporting schedule to Form 1120S. The S corporation reports $21,880 of ordinary business income on Schedule K. The S corporation provides each shareholder with a schedule K-1, which reports their pro-rata share of the income. Taxpayer B1 receives a K-1 showing $16,410 of ordinary business income. Taxpayer B2 receives a K-1 showing $5,470 of ordinary business income. Since taxpayer B1 owns 75 percent of the shares of the S corporation, he is allocated 75 percent of the income and distributions, while taxpayer B2, who owns 25 percent of the shares, is allocated 25 percent.

Taxpayers B1 and B2 are both active in running the business, so they report the income on line 28J of Schedule E, a supporting schedule to form 1040. This same amount is then transferred to line 17 of form 1040 and included in taxable income. They also report the wages they received as

officers of the S corporation on form 1040. The second table summarizes the total income and payroll taxes paid as a result of the S corporation business activity.

Table B-2

S corporation	
Payroll taxes on for officers' compensation	$6,120
Taxpayer B1	
Payroll taxes withheld on $40,000 compensation	$3,060
Federal income tax on $16,410 business income (25% bracket)	$4,103
Federal income tax on $40,000 wages received as officer (25% bracket)	$10,000
Minnesota income tax on $16,410 business income (7.05% bracket)	$1,157
State income tax on $40,000 wages received as officer (7.05% bracket)	$2,820
Total paid by B1	$21,139
Taxpayer B2	
Payroll taxes withheld on $40,000 compensation	$3,060
Federal income tax on $5,470 business income (25% bracket)	$1,368
Federal income tax on $40,000 wages received as officer (25% bracket)	$10,000
Minnesota income tax on $5,470 business income (7.05% bracket)	$386
State income tax on $40,000 wages received as officer (7.05% bracket)	$2,820
Total paid by B2	$17,633

One advantage of operating a business as an S corporation is that payroll taxes only apply to the compensation paid to the officers, and not to the business income that flows through to Schedule E.[31] This contrasts with the treatment of a sole proprietorship or a partnership, in which the net profit of the business is subject to payroll taxes. The IRS requires S corporations to maintain a "reasonable" level of compensation of officers and may reallocate income from the ordinary business income to compensation of officers, thus subjecting it to payroll taxes, if they determine that the S corporation is attempting to avoid payroll taxes by setting the officers' compensation too low and the ordinary business income too high.

[31] Note that doing this will adversely affect the shareholder/employee's Social Security benefit entitlements, since the shareholder/employee will have a lower earnings history. For higher income individuals, this is typically a minor consideration since their return on Social Security taxes paid is negative—i.e., the present value of Social Security taxes paid is less then the present value of the benefit entitlements earned. That may not be the case for individuals with very low earnings histories. Social Security death and disability benefits further complicate the calculations.

S corporations are not required to actually distribute the income for the year to the shareholders; many choose to retain all or part of the income as working capital for the business. But the shareholders' pro-rata shares of income still must be reported to them on Schedule K-1, and they must include it on Schedule E of their federal tax return and pay income tax on the income, even though they never actually received it. This is sometimes referred to as "phantom income." Taxpayers B1 and B2 adjust their basis in the S corporation upward by the amount not distributed. This will result in B1 and B2 realizing a smaller gain (and paying less tax) in the event they sell their shares in the S corporation. The next table shows the basis adjustment calculation for B1 and B2.

Table B-3

Taxpayer B1	
Original basis (capital contributed to start business)	$75,000
Income not distributed	$16,410
Adjusted basis	$91,410
Taxpayer B2	
Original basis (capital contributed to start business)	$25,000
Income not distributed	$5,470
Adjusted basis	$30,470

If taxpayer B2 sold his share of the business for $50,000, his gain would be $19,530, since his original basis of $25,000 was adjusted upward by the amount of income not distributed.

In practice, many S corporations typically distribute at least enough income to shareholders to cover the federal and state tax due on that income. To accomplish that, the S corporation would distribute $7,013 of income and retain $20,127 for working capital moving into the next year. Taxpayer B1 would get 75 percent of the amount distributed, or $5,259, enough to pay the $4,103 in federal income tax and $1,157 in state income tax on his full $16,410 share of the business income. Taxpayer B2 would receive 25 percent of the amount distributed, or $1,753, which would cover the $1,368 in federal income tax and the $386 in state income tax he has to pay on his full $5,470 share of the business income. In that situation, taxpayer B1 would adjust his basis in the business upward by $11,151 (the $16,410 of business income, minus the $5,259 distribution). Taxpayer B2 would adjust his basis upward by $3,717 (the $5,470 of business income, minus the $1,753 distribution).

Appendix C: 2007 Data Including Returns with Losses

Distribution of Returns with Proprietor or Pass-through Income or Loss		
	Percent with Sole Proprietor income or loss	Percent with S corporation/partnership income or loss
No liability	20.3%	5.1%
5.35 percent bracket	15.5	4.0
7.05 percent bracket	15.3	7.5
7.85 percent bracket	20.1	31.0
All filers	16.5	7.6
9.25 percent bracket ($250,000)	23.6	48.7
9.0 percent bracket ($300,000)	23.2	51.4

Distribution of Income by Income Type for Returns with Proprietor or Pass-through Income or Loss			
	FAGI	Sole proprietor income	S corporation/partnership income
No liability	1.7%	7.0%	(9.4%)
5.35 percent bracket	14.2	20.8	1.4
7.05 percent bracket	47.9	37.4	10.3
7.85 percent bracket	36.3	34.8	97.7
9.25 percent bracket ($250,000)	23.7	20.1	82.3
9.0 percent bracket ($300,000)	21.7	16.6	79.2

Pass-through Income as a Percent of FAGI for Returns with Proprietor or Pass-through Income or Loss		
	Sole Proprietor income or loss as a percent of FAGI	S corporation/partnership income or loss as a percent of FAGI
5.35 percent bracket	21.7%	10.5%
7.05 percent bracket	12.4	13.5
7.85 percent bracket	10.6	29.8
All filers	13.6	24.4
9.25 percent bracket ($250,000)	8.6	30.4
9.0 percent bracket ($300,000)	7.8	30.9

Percent of Returns with Proprietor or Pass-through Income Greater than 20 percent of FAGI, Returns with Proprietor or Pass-through Income or Loss		
	Sole Proprietor income or loss greater than 20 percent of FAGI	S corporation/partnership income or loss greater than 20 percent of FAGI
5.35 percent bracket	5.9%	1.3%
7.05 percent bracket	3.1	2.1
7.85 percent bracket	4.3	14.9
All filers	5.7	2.7
9.25 percent bracket ($250,000)	4.5	23.7
9.0 percent bracket ($300,000)	4.1	25.9

For more information about income and corporate taxes, visit the taxes area of our website, www.house.mn/hrd/hrd.htm.