

# Partnerships & Partners

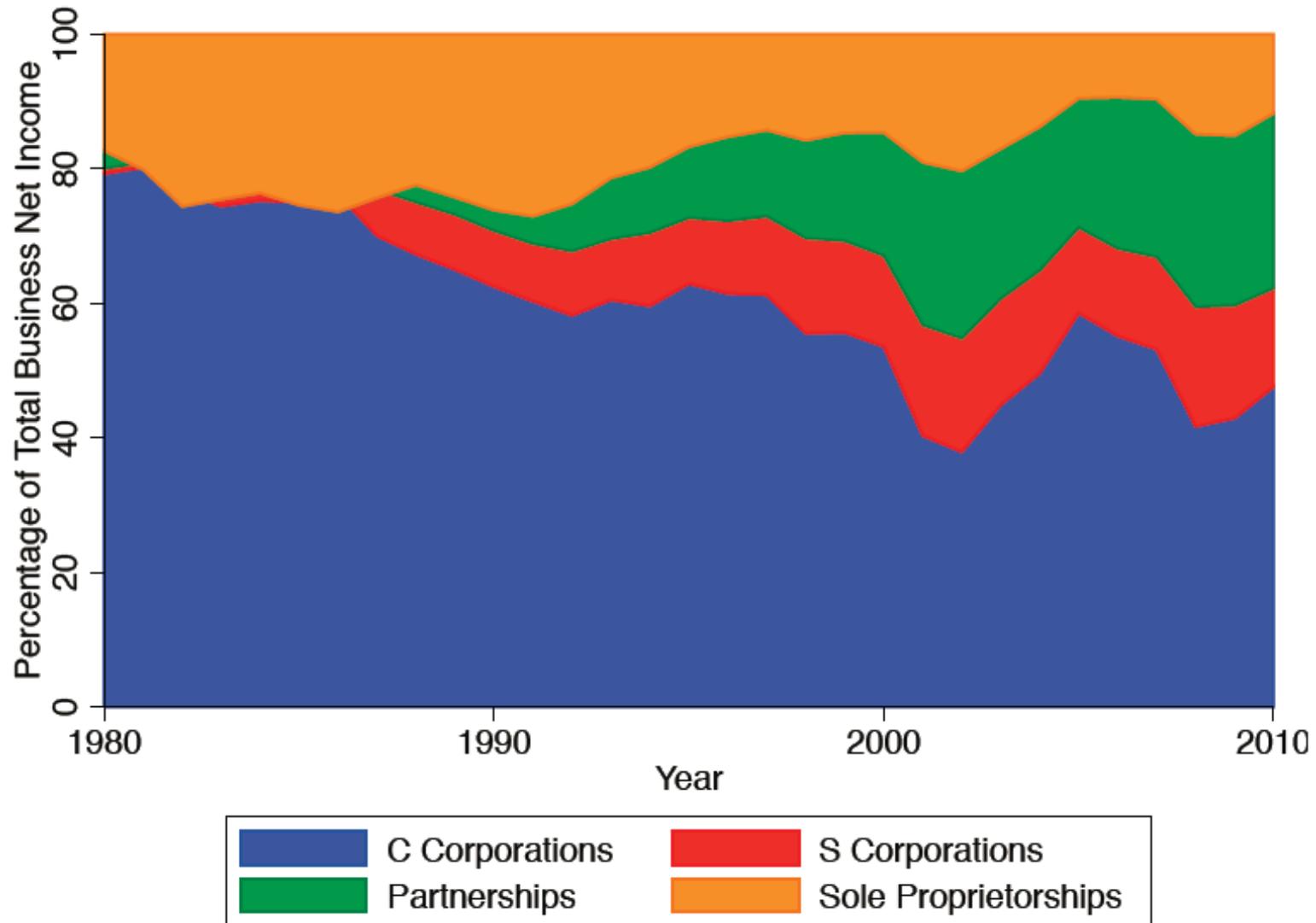
## Who and How Much?

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The views expressed here are those of the authors and do not necessarily reflect the views of the Treasury Department.

# The Rise of Pass-through Businesses

Percentage of Total Net Business Income by Entity Type, 1980-2010



# ROADMAP

## Following the Money:

1. Link businesses to their owners.
2. Determine the tax paid for each business's activity.

## To Whose Benefit:

1. Pass-through business income is especially concentrated.
2. Average federal income tax rate on pass-throughs is 19%.

# Partnerships file a business income tax return...

Form <b>1065</b> Department of the Treasury Internal Revenue Service	<b>U.S. Return of Partnership Income</b> For calendar year 2011, or tax year beginning _____, 2011, ending _____, 20_____. ▶ See separate instructions.	OMB No. 1545-0099 <span style="font-size: 2em; font-weight: bold;">2011</span>				
<b>A</b> Principal business activity  <b>B</b> Principal product or service  <b>C</b> Business code number	<table border="1" style="width:100%; border-collapse: collapse;"> <tr> <td style="width:10%; text-align: center; vertical-align: middle;"><b>Print or type.</b></td> <td style="padding: 2px;">Name of partnership</td> </tr> <tr> <td style="padding: 2px;">Number, street, and room or suite no. If a P.O. box, see the instructions.</td> </tr> <tr> <td style="padding: 2px;">City or town, state, and ZIP code</td> </tr> </table>	<b>Print or type.</b>	Name of partnership	Number, street, and room or suite no. If a P.O. box, see the instructions.	City or town, state, and ZIP code	<b>D</b> Employer identification number  <b>E</b> Date business started  <b>F</b> Total assets (see the instructions) \$ _____
<b>Print or type.</b>	Name of partnership					
Number, street, and room or suite no. If a P.O. box, see the instructions.						
City or town, state, and ZIP code						
<b>G</b> Check applicable boxes: (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change (5) <input type="checkbox"/> Amended return (6) <input type="checkbox"/> Technical termination - also check (1) or (2)						
<b>H</b> Check accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ▶ _____						
<b>I</b> Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ _____						
<b>J</b> Check if Schedules C and M-3 are attached <input type="checkbox"/>						

**Caution.** Include *only* trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.

<b>Income</b>	<b>1a</b> Merchant card and third-party payments (including amounts reported on Form(s) 1099-K). For 2011, enter -0- . . . . .	<b>1a</b>					
	<b>b</b> Gross receipts or sales not reported on line 1a (see instructions)	<b>1b</b>					
	<b>c</b> Total. Add lines 1a and 1b . . . . .	<b>1c</b>					
	<b>d</b> Returns and allowances plus any other adjustments to line 1a (see instructions) . . . . .	<b>1d</b>					
	<b>e</b> Subtract line 1d from line 1c . . . . .	<b>1e</b>					
	<b>2</b> Cost of goods sold (attach Form 1125-A) . . . . .	<b>2</b>					
	<b>3</b> Gross profit. Subtract line 2 from line 1e . . . . .	<b>3</b>					
	<b>4</b> Ordinary income (loss) from other partnerships, estates, and trusts (attach statement) . . . . .	<b>4</b>					
<b>5</b> Net farm profit (loss) (attach Schedule F (Form 1040)) . . . . .	<b>5</b>						
<b>6</b> Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797) . . . . .	<b>6</b>						
<b>7</b> Other income (loss) (attach statement) . . . . .	<b>7</b>						
<b>8</b> <b>Total income (loss).</b> Combine lines 3 through 7 . . . . .	<b>8</b>						
<b>(limitations)</b>	<b>9</b> Salaries and wages (other than to partners) (less employment credits) . . . . .	<b>9</b>					
	<b>10</b> Guaranteed payments to partners . . . . .	<b>10</b>					
	<b>11</b> Repairs and maintenance . . . . .	<b>11</b>					

...which lists allocations only by partner type...

**Analysis of Net Income (Loss)**

<b>1</b>	Net income (loss). Combine Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13d, and 16l . . . . .					<b>1</b>	
<b>2</b>	Analysis by partner type:						
	<b>(i)</b> Corporate	<b>(ii)</b> Individual (active)	<b>(iii)</b> Individual (passive)	<b>(iv)</b> Partnership	<b>(v)</b> Exempt organization	<b>(vi)</b> Nominee/Other	
<b>a</b>	General partners						
<b>b</b>	Limited partners						

...but are reflected in K-1s (issued *per partner*)

**Schedule K-1  
(Form 1065)**

Department of the Treasury  
Internal Revenue Service

**2011**

For calendar year 2011, or tax  
year beginning \_\_\_\_\_, 2011  
ending \_\_\_\_\_, 20\_\_\_\_

**Partner's Share of Income, Deductions,  
Credits, etc.** ▶ See back of form and separate instructions.

Final K-1

Amended K-1

OMB No. 1545-0099

**Part III Partner's Share of Current Year Income,  
Deductions, Credits, and Other Items**

<b>1</b>	Ordinary business income (loss)	<b>15</b>	Credits
<b>2</b>	Net rental real estate income (loss)		
<b>3</b>	Other net rental income (loss)	<b>16</b>	Foreign transactions
<b>4</b>	Guaranteed payments		
<b>5</b>	Interest income		
<b>6a</b>	Ordinary dividends		
<b>6b</b>	Qualified dividends		
<b>7</b>	Royalties		
<b>8</b>	Net short-term capital gain (loss)		
<b>9a</b>	Net long-term capital gain (loss)	<b>17</b>	Alternative minimum tax (AMT) items
<b>9b</b>	Collectibles (28%) gain (loss)		
<b>9c</b>	Unrecaptured section 1250 gain		
<b>10</b>	Net section 1231 gain (loss)	<b>18</b>	Tax-exempt income and nondeductible expenses
<b>11</b>	Other income (loss)		

**Part I Information About the Partnership**

**A** Partnership's employer identification number

**B** Partnership's name, address, city, state, and ZIP code

**C** IRS Center where partnership filed return

**D**  Check if this is a publicly traded partnership (PTP)

**Part II Information About the Partner**

**E** Partner's identifying number

**F** Partner's name, address, city, state, and ZIP code

# Linking Partnerships to Partners

- **Data Challenge:** Owners can be one of many entity types, and different kinds of returns are processed by different systems.
- **Our Procedure:** link K-1's to partnership returns by merging on the Document Locator Number (DLN).
  - We link 25.5 million K-1s to the 3.6 million partnerships
    - Match 97.7% of partnerships to a K-1
    - Match 98% of aggregate ordinary business income

# CLASSIFYING PARTNERS

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Partner Type	Form Filed
Individual	1040
C- and other corporations	1120, 1120j $\forall j \in \{F, PC, L, RIC, REIT, H, C, POL, ND, SF, FSC\}$
S-corporations	1120S
Tax-exempt	990, 990j $\forall j \in \{T, R, PF, ZR, C\}$
Estate/trust	1041
Foreign person/entity	1042, 1042S, 8805, 8288A
Partnerships	1065, 1065B, 1066
Unidentified EIN	Taxpayer identifier classifiable as EIN, but tax form unknown
Unidentified TIN type	Taxpayer identifier not classifiable

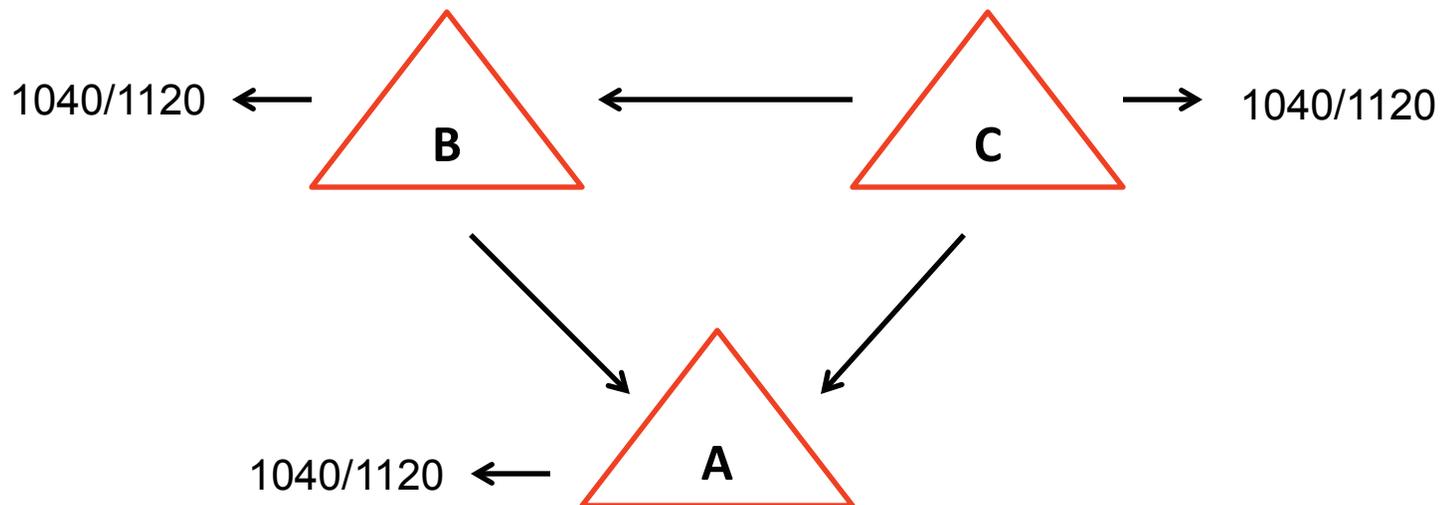
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# Partnerships with Partnership Partners

- Partnerships can be owned by other partnerships
- Not problematic for sector-wide analyses
- Problematic for industry breakdowns and possibly audits

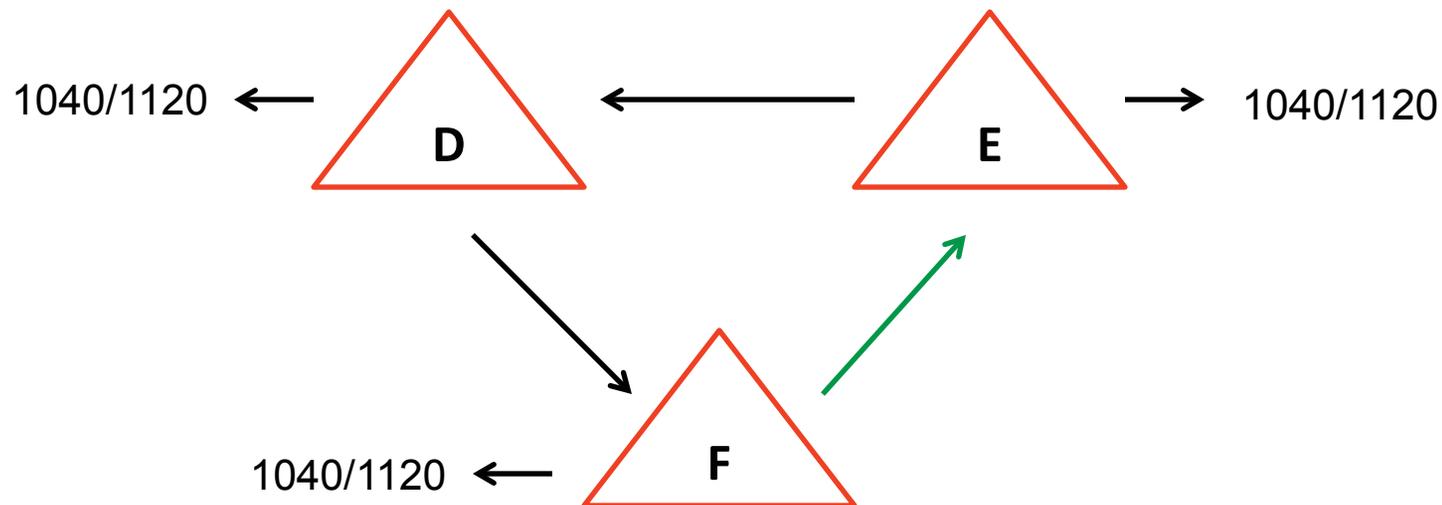
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- Use recursive algorithm to trace income through tiers until only 'nontransparent' partnerships remain

# Linking Other Business Types to Their Owners

- **S-Corporations:**

- Owners must not be other business entities
- Each owner receives pro-rata share of income
- Link 1120-S K-1s to Shareholder's Form 1040
  - We match 7.2 million K-1s from the 4.5 million S-corporations to 4.8 million individuals

- **Sole Proprietorships:**

- Income reported directly on Form 1040

- **C-Corporations:**

- Owners are not identifiable
- Use dividend income from Form 1040 link K-1's to partnership returns by merging on the Document Locator Number (DLN).

# TAX RATES ON INCOME DISTRIBUTED TO PARTNERS

## CALCULATED RATES

$$T_{ik} = \begin{cases} T_{ik}^{\text{OTA}} = \frac{TAX_{ik}}{Y_{ik}} & \text{if } k \text{ files form } \in \{1040, 1120, 1120S\} \\ T_{ik}^{\text{Assigned}} & \text{otherwise} \end{cases}$$

where

- ▶  $T_{ik} \equiv$  tax rate on income type  $i$  to partner  $k$  from all partnerships  $p$
- ▶  $i \equiv$  income type in {capital gains, dividends, ordinary business income, interest}
- ▶  $Y_{ik} \equiv$  sum of payment of income type  $i$  to partner  $k$  from all partnerships
- ▶  $TAX_{ik} \equiv$  change in tax liability from the OTA tax calculator

# TAX RATES ON INCOME DISTRIBUTED TO PARTNERS

## ASSIGNED RATES

$$T_{ik}^{\text{Assigned}} = \begin{cases} T_{i,1040}^{\text{OTA}} & \text{if } form \in \{1120\text{-RIC}, 1120\text{-REIT}, 1066, 1041\} \\ T_{i,1120}^{\text{OTA}} & \text{if } form \in \{1120j\} \forall j \in \{F, PC, L, H, C, POL, ND, SF, FSC\} \\ .025 & \text{if } form \in \{8805, 1042S, 8288A, 1042\} \\ 0 & \text{if } form \in \{990, 990j\} \forall j \in \{T, R, PF, ZR, C\} \\ \frac{.025 + T_{i,1120}^{\text{OTA}}}{2} & \text{if } k \text{ has unidentified EIN or tin type} \end{cases}$$

where

- ▶ *form* is the tax form partner *k* files
- ▶  $T_{i,1040}^{\text{OTA}}$  is the tax rate for individuals from the OTA tax calculator for income type *i*
- ▶  $T_{i,1120}^{\text{OTA}}$  is the tax rate for C-corporations

## AGGREGATING TAX RATES

### Partnership Rates

$$T_p = \left( \frac{\sum_{i \in \mathcal{I}} \sum_{k \in \mathcal{K}} T_{ik} Y_{ikp}}{Y_p} \right)$$

where

- ▶ the numerator is the sum of tax liabilities over income types  $i$  and partners  $k$  associated with payments from partnership  $p$
- ▶ the denominator is the total payments from partnership  $p$

### Partnership Sector Rate

$$T = \left( \frac{\sum_{i \in \mathcal{I}} \sum_{k \in \mathcal{K}} \sum_{p \in \mathcal{P}} T_{ik} Y_{ikp}}{Y} \right)$$

where

- ▶ the numerator is the sum of tax liabilities from payments from partnerships
- ▶ the denominator is the total payments from all partnerships

## TAX RATES ON OTHER BUSINESS TYPES

### 1. S-Corporations

- ▶  $TAX_S \equiv$  Actual tax minus hypothetical tax with zero 1120S income
- ▶ Tax rate is  $TAX_S$  divided by actual 1120S income

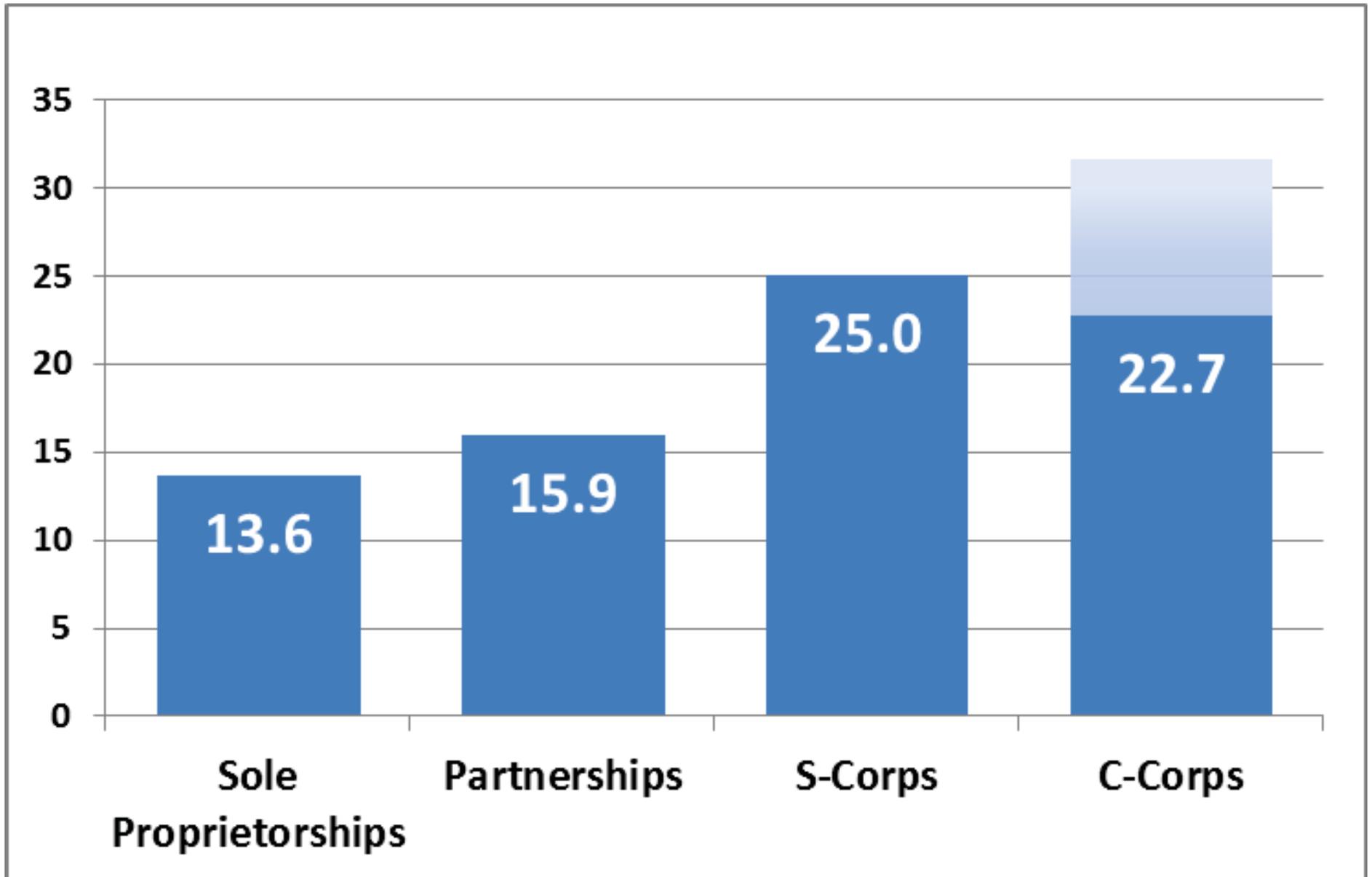
### 2. Sole Proprietorships

- ▶ Same method as S-Corporations

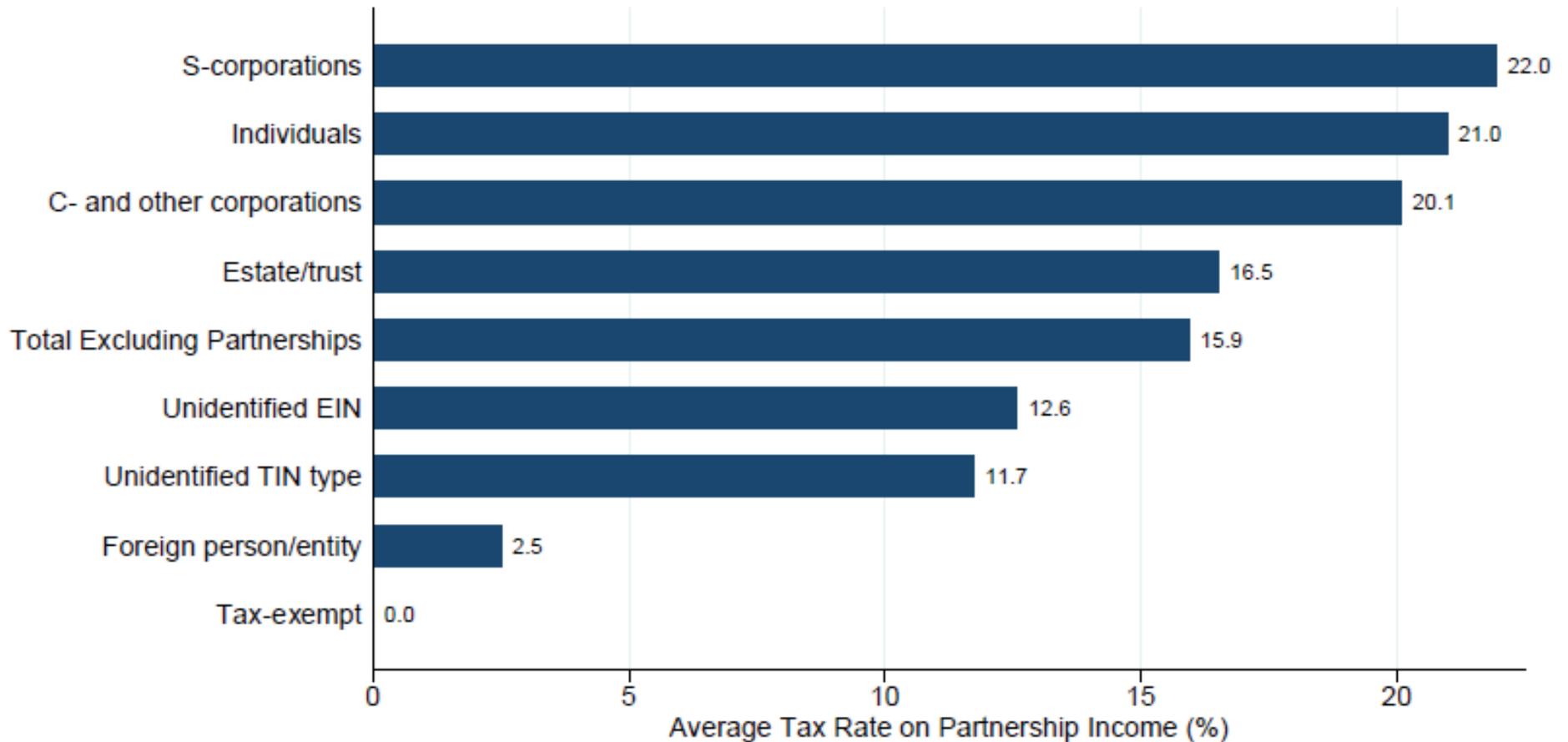
### 3. C-Corporations

- ▶  $TAX_{C1} \equiv$  Actual taxes paid
- ▶ First layer is  $TAX_{C1}$  divided by taxable income
- ▶  $TAX_{C2} \equiv$  Estimate from Poterba (2004) for dividend+cap gains tax times income net of first layer of tax
- ▶ Final rate combines first and second layer of tax

# Average Tax Rate by Entity Type



# Average Tax Rates on Partnership Income



# ROADMAP

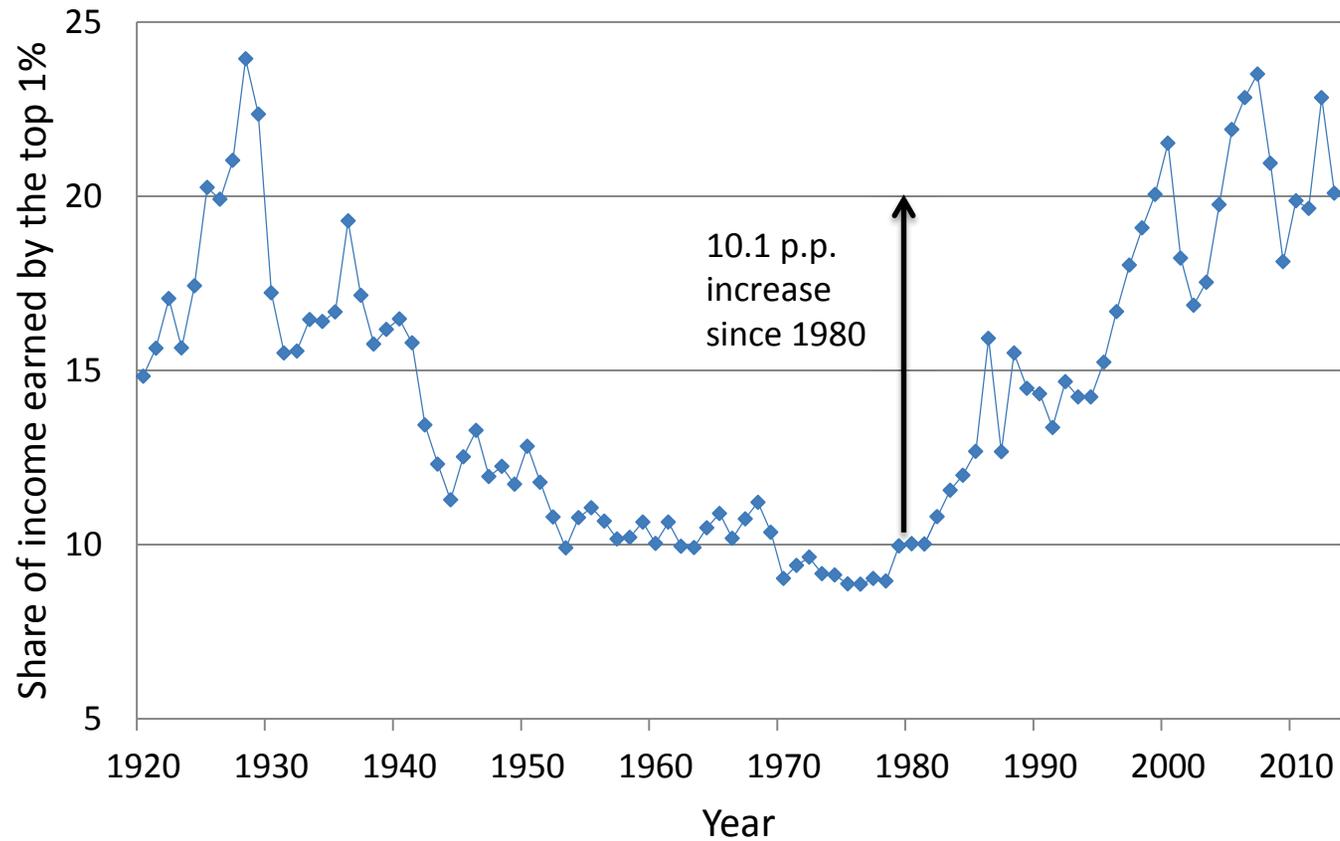
## Following the Money:

1. Link businesses to their owners.
2. Determine the tax paid for each business's activity.

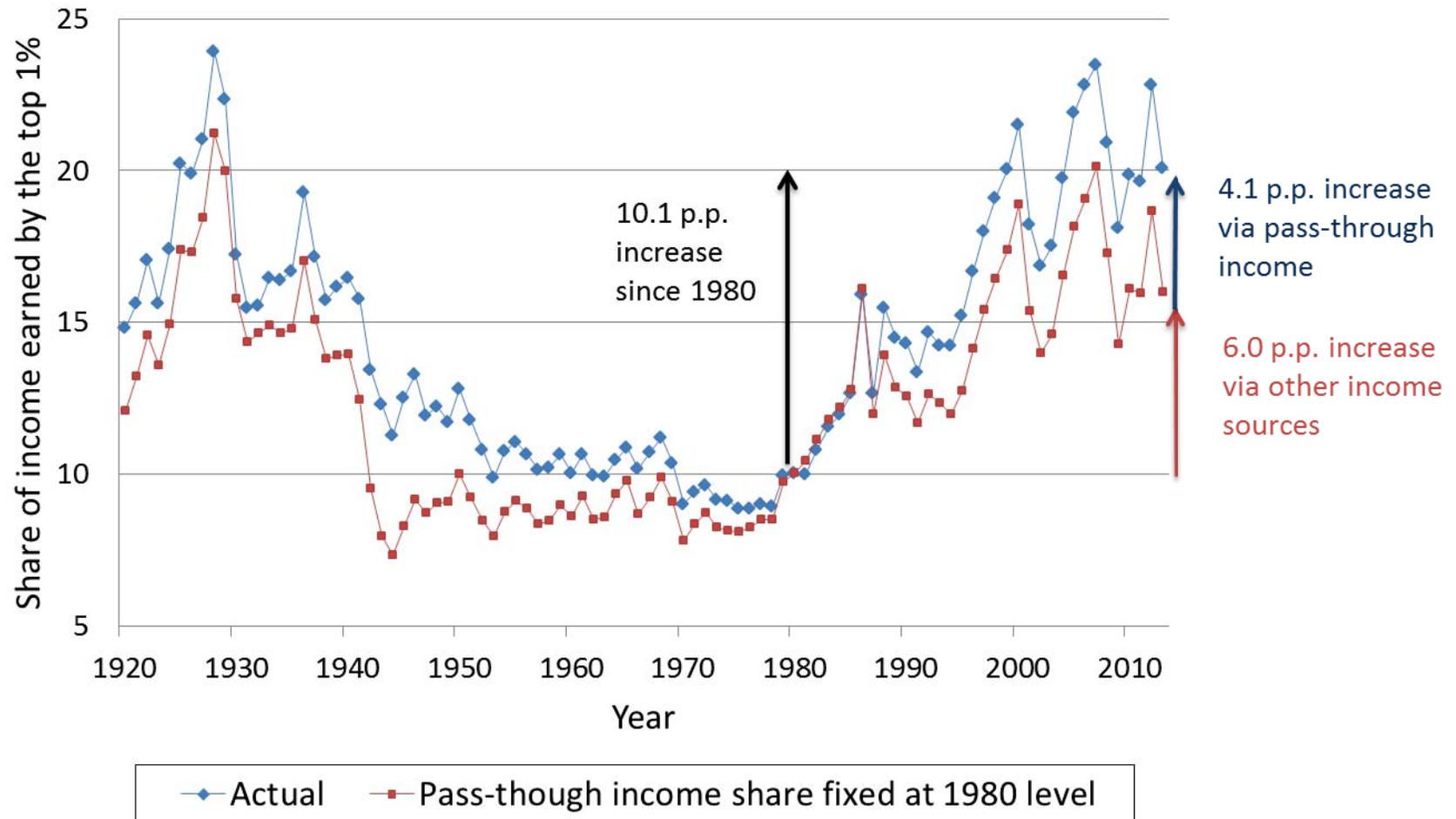
## To Whose Benefit:

1. Who receives pass-through business income?
2. Average federal income tax rate on pass-throughs is 19%.
3. 30% of income earned by partnerships cannot be unambiguously traced to an identifiable, ultimate owner.

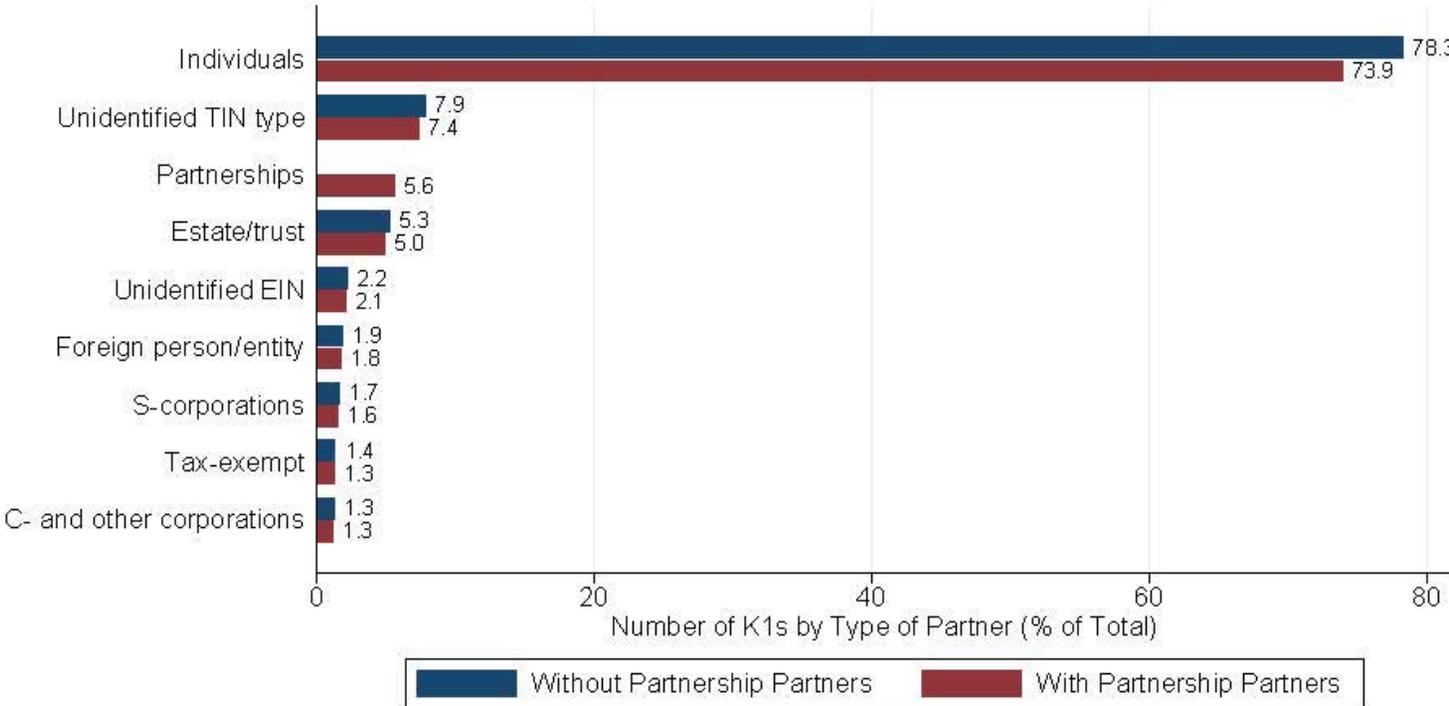
# The Top 1% Income Share



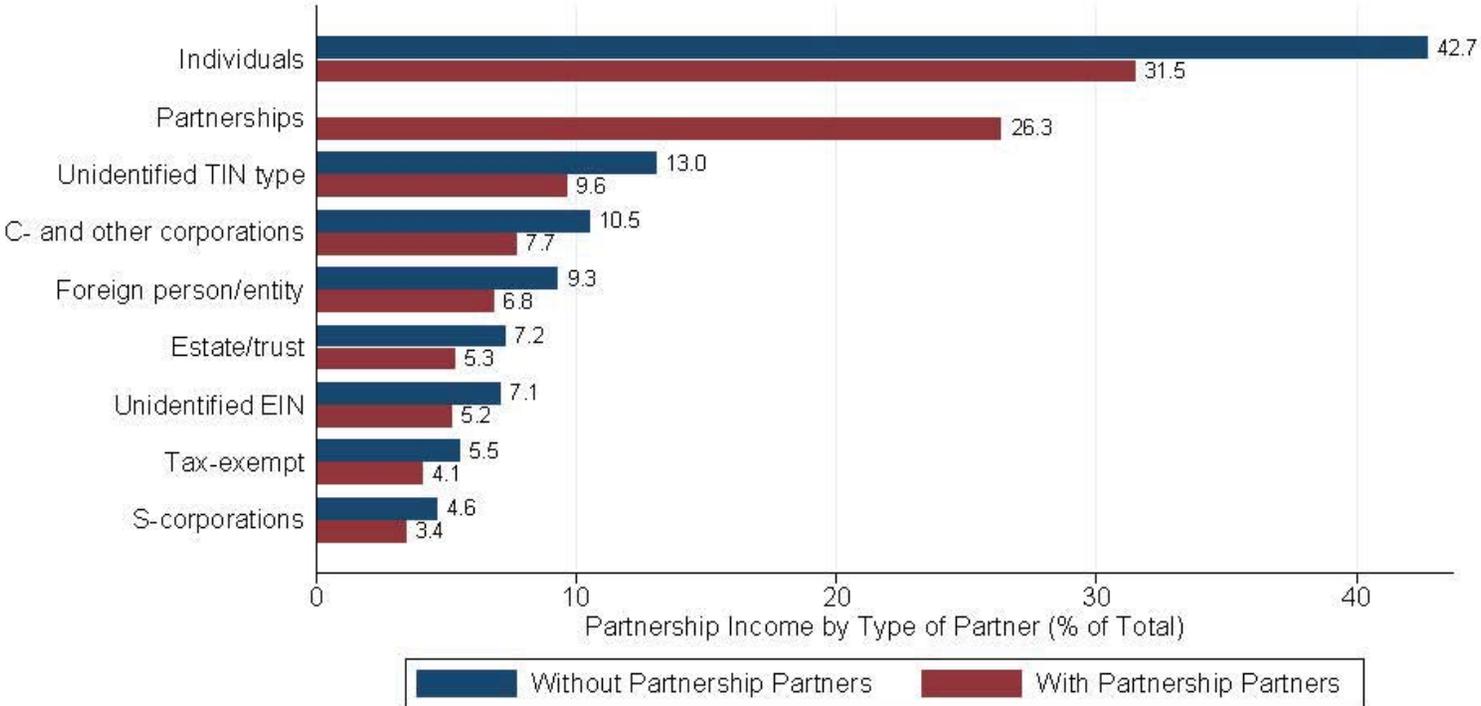
# Pass-through Income and the 1% Income Share



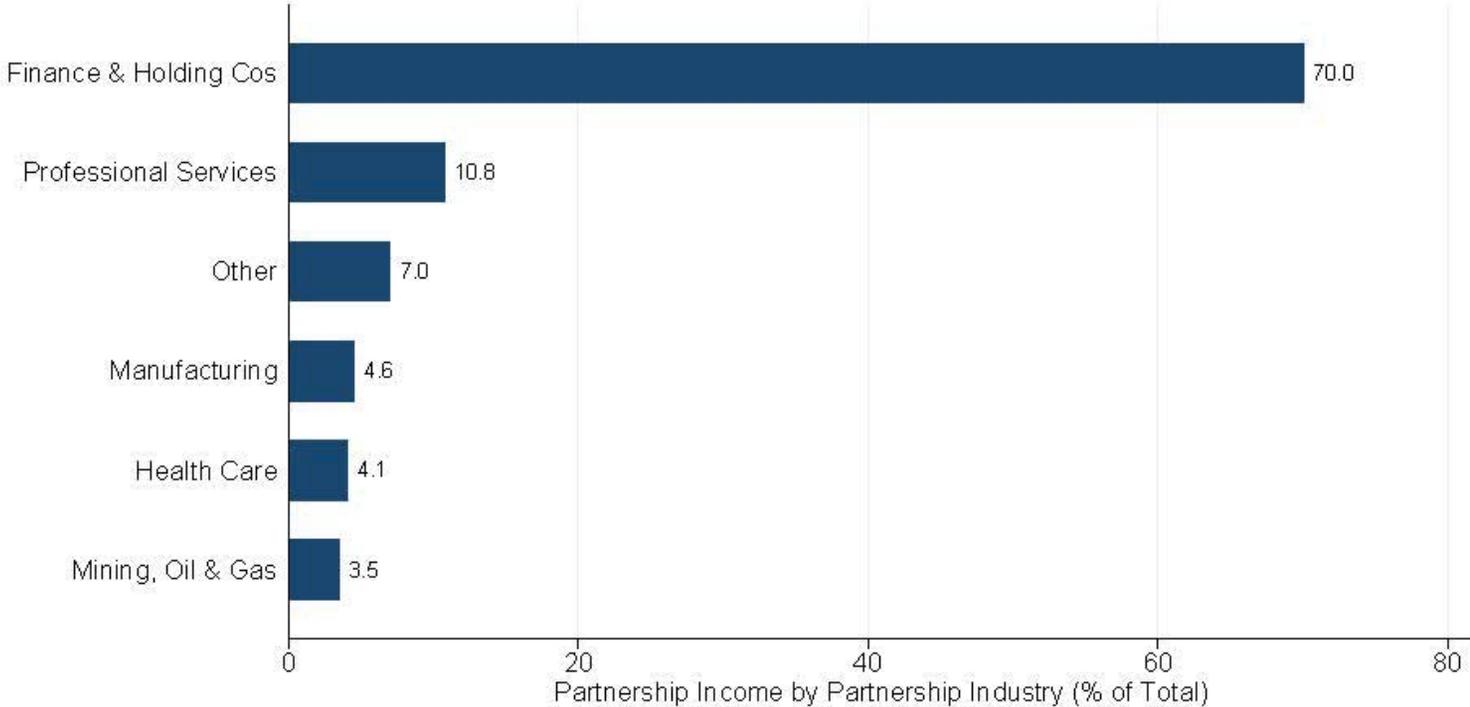
# NUMBER OF K1s BY TYPE OF PARTNER



# INCOME SHARES BY TYPE OF PARTNER

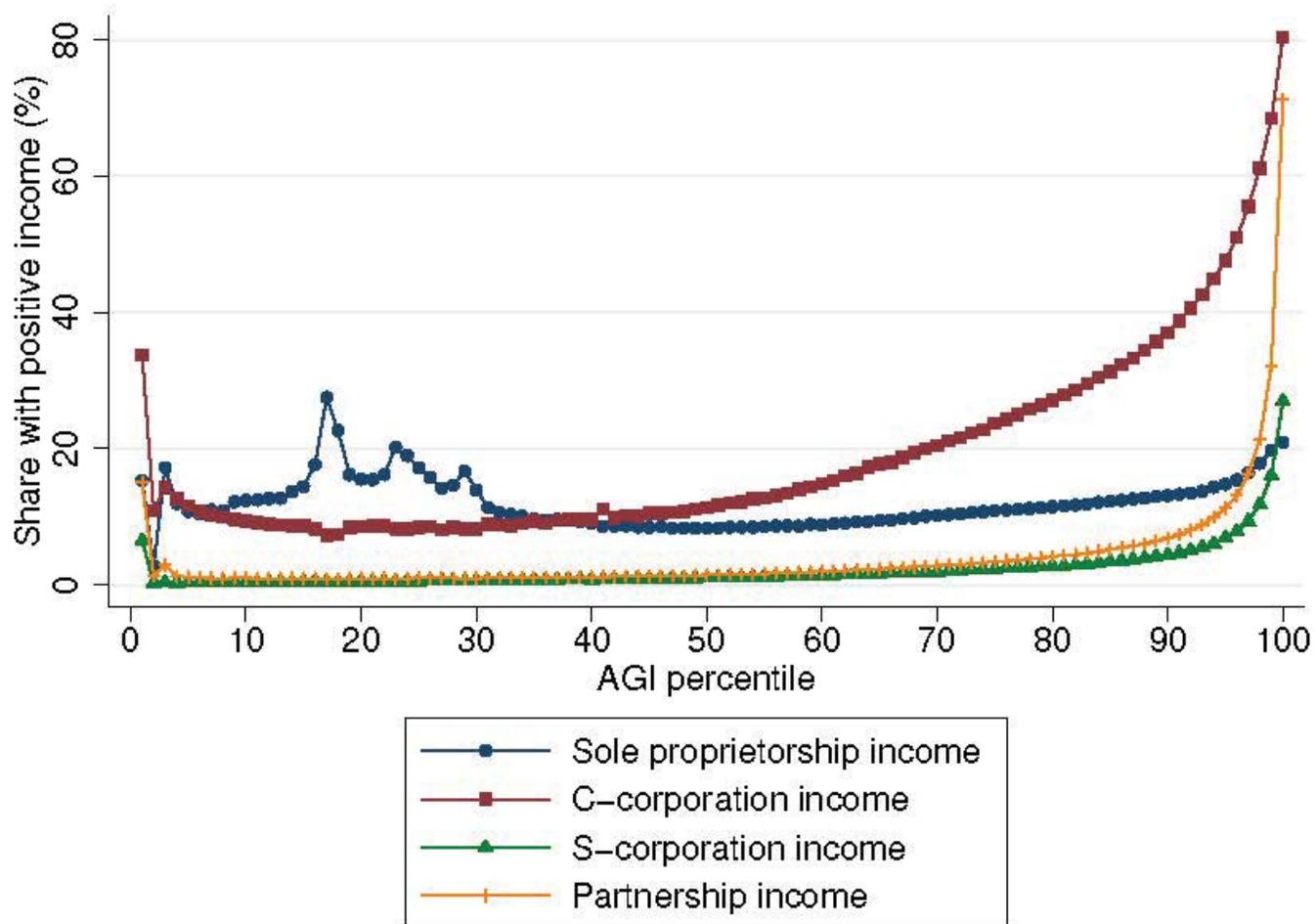


# PARTNERSHIP INCOME SHARES BY INDUSTRY

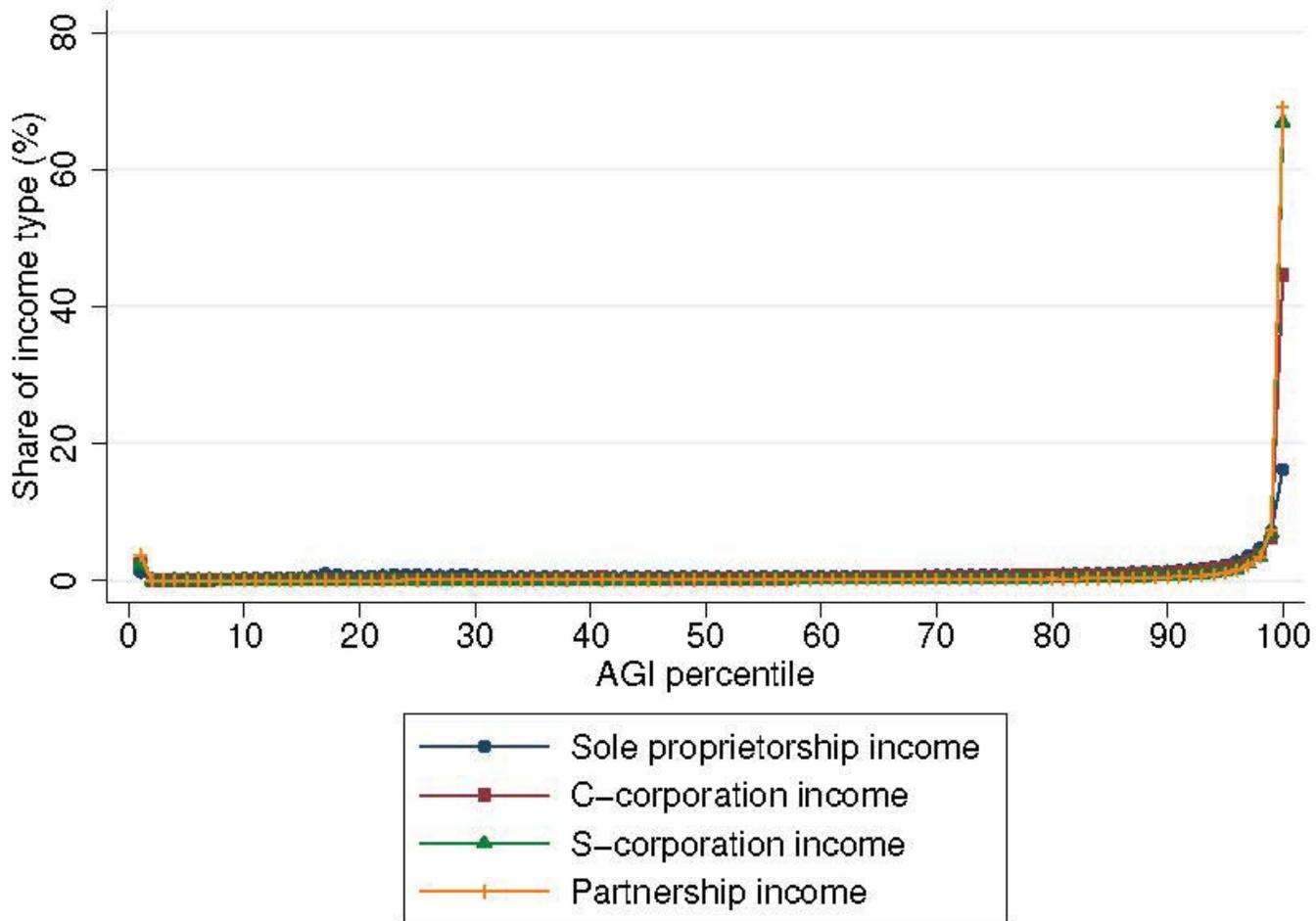


Note: "Finance & Holding Cos" includes real estate and rental partnerships ( $\approx 3.1\%$  of total)

# BUSINESS PARTICIPATION RATES BY AGI PCTILE

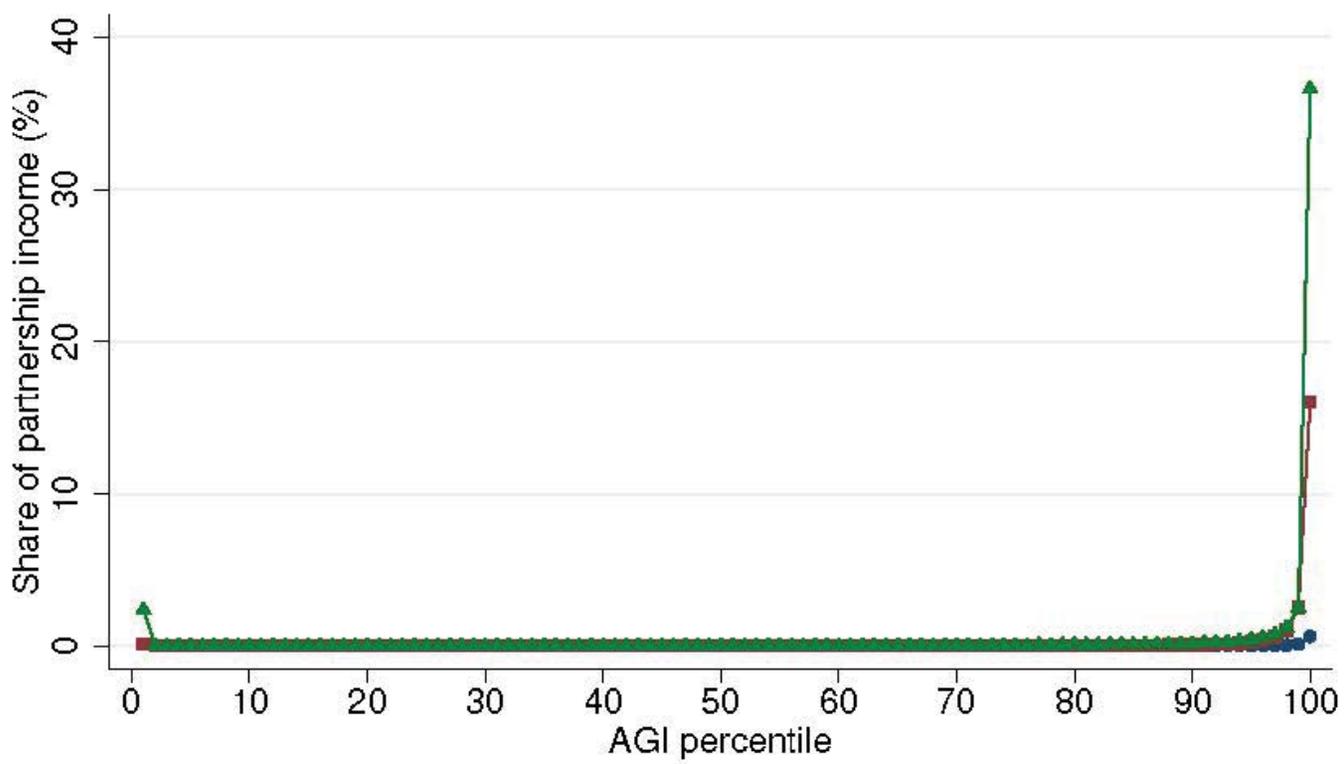


# BUSINESS INCOME SHARES BY AGI PCTILE



# PARTNERSHIP INCOME SHARES BY AGI PCTILE

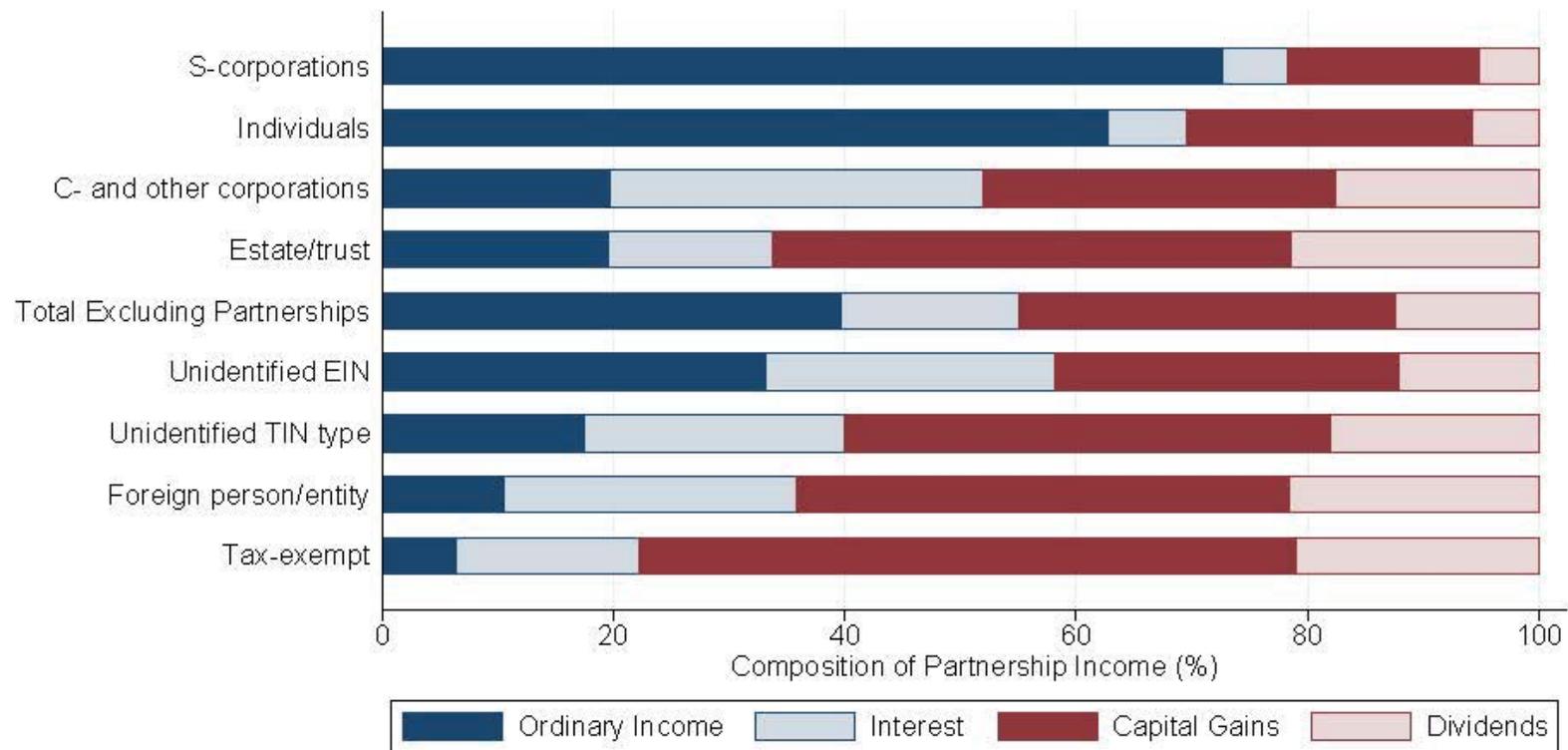
THREE SAMPLE INDUSTRIES



- Accommodation and Food Service (NAICS 72)
- Professional Services (NAICS 54)
- ▲— Finance, Holding Companies (NAICS 52, 55, and 531)

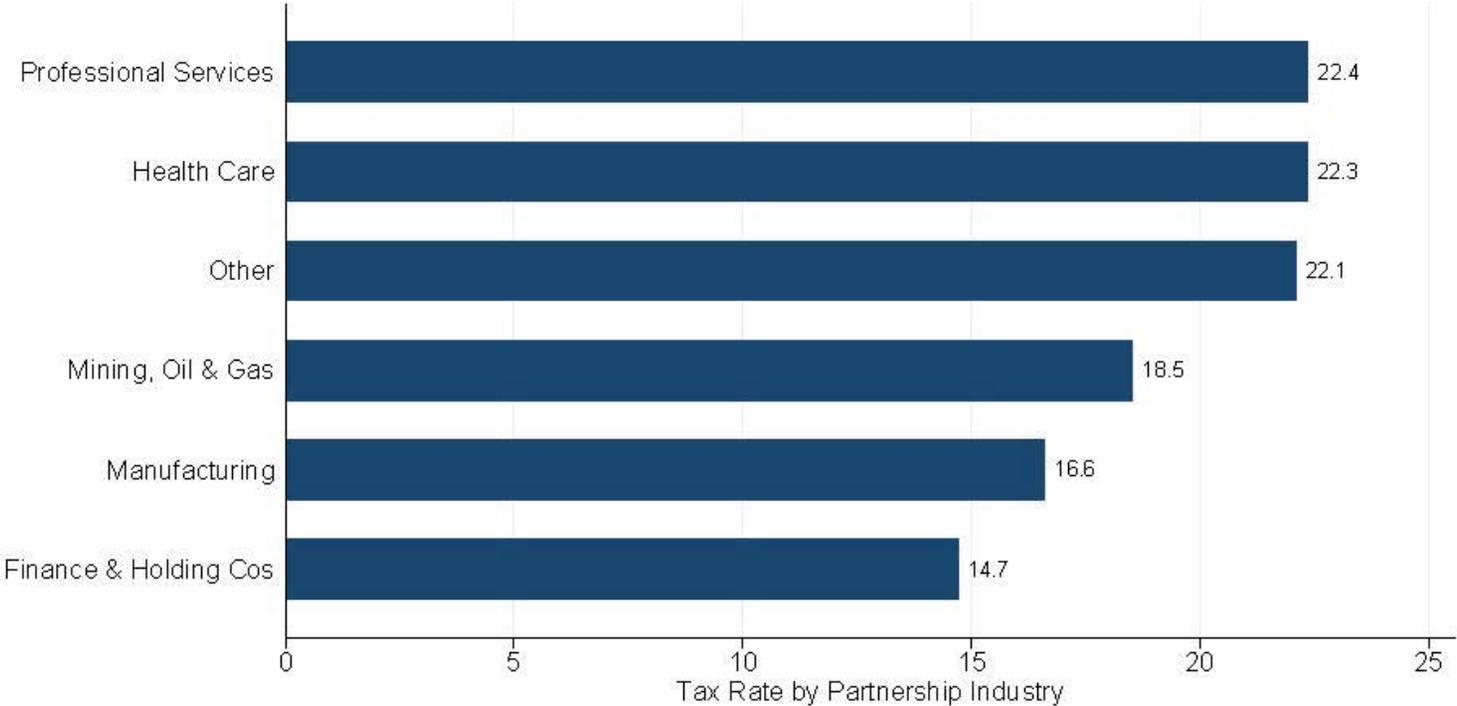
# PARTNERSHIP INCOME TYPE DISTRIBUTION

BY TYPE OF PARTNER



# TAX RATES ON PARTNERSHIP INCOME

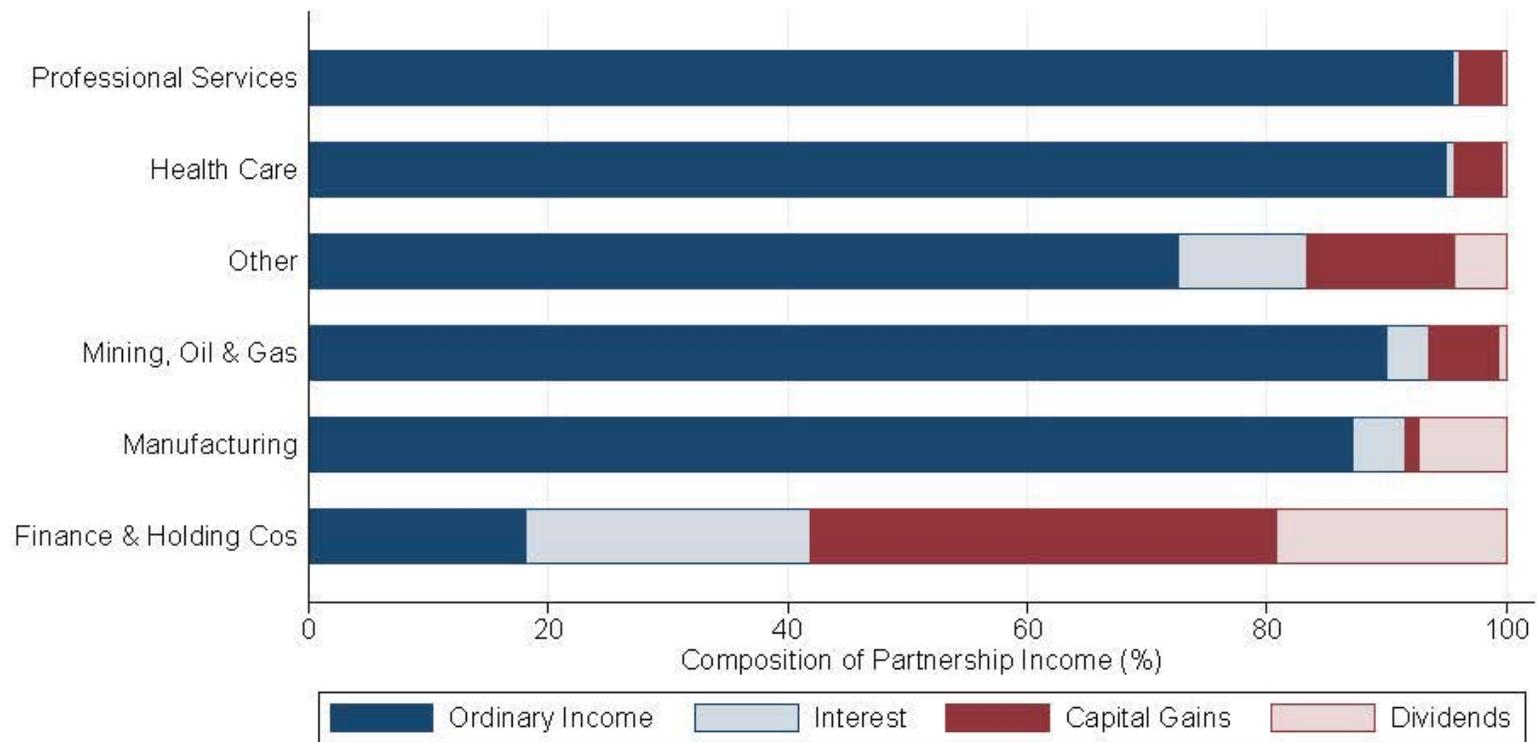
## BY INDUSTRY



Note: "Finance & Holding Cos" includes real estate and rental partnerships ( $\approx 3.1\%$  of total)

# PARTNERSHIP INCOME TYPE DISTRIBUTION

## BY INDUSTRY



Note: "Finance & Holding Cos" includes real estate and rental partnerships ( $\approx 3.1\%$  of total)

# Partnership Ownership is Opaque

In many cases, we can not directly link the business activity of partnership to the ultimate owner.

- 20% of income earned by unclassifiable partners
  - We can not match 2.4 million K-1s to a tax return for the partner
  - Use income type allocations to “guess” applicable rate
- Not all partnership income can be uniquely linked to an originating partnership
  - 22,417 partnerships lack definitive linkages between firm and all owners
  - They account for approximately \$100 billion in income
  - The average tax rate on this income is 8.8%.

# Conclusion

1. The Rise of Pass-throughs: U.S. business activity is migrating from corporations to pass-throughs.
2. Who Owns Partnerships?
  - About half of partnership income taxed on individual returns.
  - At least 15% to foreign or tax exempt entities with little tax.
  - At least 10% to C-corporations.
  - Remaining ownership is opaque.
3. How Much Tax Do They Pay?
  - In 2011 the average tax rate on pass-through income was 19%.
4. Implication: The rise of pass-throughs has lowered the average tax rate on business income and as a result tax receipts are lower than they would otherwise be.

