PARTNERSHIPS IN THE UNITED STATES: WHO OWNS THEM AND HOW MUCH TAX DO THEY PAY?

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The share of U.S. business income earned by partnerships has doubled from 10% to 20% since 1993. What are the consequences of this rise for effective tax rates on business activity? We use data drawn from the universe of U.S. tax returns to describe who owns partnerships and to quantify how much tax revenue is attributable to partnership activity. We first use information returns (1065-K1's) and income tax returns (e.g. 1040's and 1120's) to connect the income of partnerships through partnership tiers to their ultimate U.S. owners: individuals, corporations, and tax-exempt entities. We then use the income allocated to each owner in order to calculate average and marginal tax rates paid by partnerships over time and across industries (e.g. law firms versus hedge funds). The paper has important implications for effective tax rates on U.S. business activity and the potential effects of tax reform in the large and growing partnership sector.

Background Information

A partnership is a trade or business that does not pay tax directly. Instead, a partnership's income is attributed to its owners who are responsible for tax payments. Individual partners pay tax under the individual income tax code and the payroll tax code. Corporate partners pay tax under the corporate income tax code and then potentially again when profits are distributed to owners of the corporation. Partners that are estates and trusts also pay income taxes. Tax-exempt partners avoid taxation unless the partnership's activity produces unrelated business income. Foreign partners pay income tax according to their home country's rules.

This complicated structure makes it difficult to evaluate who owns partnerships and how much tax is attributable to the activities of partnerships. This project tries to answer these two questions via new analysis of the population of tax records of partnerships and their partners. The first section of the project connects partnership income to the owners receiving that income. This requires matching information returns (1065-K1s) to the corresponding tax returns (1120, 1120S, 1040, 1041, etc.) filed with the IRS. The mapping allows us to explore what types of businesses enter into joint ventures through a partnership structure and will prove useful in future projects as we attempt to connect other types of information returns (e.g W-2s) between businesses, owners, and employees. The second section of the project takes the income received by owners and calculates an average and marginal tax rate on this income. In the calculation, we take all non-partnership income as given, thereby assigning the partner's marginal tax rate for each type of partnership income. These rates are then weighted by dollars to assign an average and marginal tax rate 'faced' by the partnership. Calculating these hypothetical rates allows a more thorough evaluation of the true tax advantage of flow-through entities like partnerships and S-corporations over traditional C-corporations.

Connecting the income distributed by partnerships to the ultimate taxpayers receiving that income allows us to characterize the distribution of partners and how this has changed over time. We decompose the ownership distribution in both equal-weighted and dollar-weighted terms, asking both how prevalent and how economically important individual, corporate, foreign, and non-profit partners are. We explore differences in ownership patterns across industries, jurisdictions, and over time. We discuss how these conclusions depend on assumptions about unallocated income and income flowing between partnerships.

Connecting partnership income to owners also allows us to compute the effective average tax rates paid by partnerships and the marginal tax rates that one might expect assuming an additional dollar of income is allocated across owners in the same way as actual income. We decompose the average and marginal tax rates by type of owner and compare across industries to better understand how tax reform proposals might affect partnerships and their owners.