

Tax Avoidance at the Top

By Danny Yagan

KEY TAKEAWAYS

- An estimated \$1 trillion of entrepreneurial business income goes to the top 1 percent of U.S. earners.
- Most of that money is estimated to be labor income rather than capital income.
- Many of these wealthy workers avoid taxes on that labor income.

“We don’t pay taxes. Only the little people pay taxes.” So goes the aphorism infamously attributed to Leona Helmsley, the billionaire who in 1989 was convicted of evading \$1.2 million in federal income taxes. She dodged taxes the old-fashioned way: by criminally claiming luxurious personal purchases as business expenses. When you think about tax avoidance at the top of the income distribution today, you probably think of multinational profits in the Caribbean islands or of hedge fund managers’ “carried interest”. Yet there is another loophole that has grown incredibly important over the last three decades: corporate form. And understanding how it works can change one’s view of how high-earners often make their money in the first place.

To set the stage, we know from the pioneering work of Piketty and Saez (2003) and Piketty, Saez, and Zucman (2018) that top earners take home a substantially larger share of the country’s income today than they did in the 1980s. Most of today’s top income comes in the form of business and other non-wage income like interest and rent, rather than W-2 wages. This pattern suggests a view of today’s typical top earner as idly sitting back and watching their income roll in from stocks, bonds, and other passive capital.

However, there are taxes that must be paid by all people — big, little and those in between. But not all taxes are equal. Policymakers have adopted the principle that capital income should be taxed at lower rates than labor income. So if at all possible, top earners will find ways to disguise their labor income as “capital” income. And one way to do that is by changing the corporate form of the businesses they own and operate themselves. This

suggests two key research questions: How much top business income is actually labor income in disguise? And how does correcting for this tax avoidance change one's view of how top earners make their money?

Matthew Smith of the U.S. Treasury Department, Owen Zidar of Princeton University, Eric Zwick of the University of Chicago, and I recently released research that found the largest chunk of top business income – over \$1 trillion of annual income from private businesses – is mostly labor income in disguise (Smith, Yagan, Zidar, and Zwick 2019). Correcting for this large-scale tax avoidance, we conclude that the top of the U.S. income scale is primarily inhabited by workers – much less by public-company CEOs whose outsized paychecks have commanded so much attention, and much more by private-company entrepreneurs working below the public radar.

And these working-rich have a tax avoidance technique – tax-preferred corporate forms – that gives them lower tax rates than other high-income workers.

Our study, based on an examination of anonymized tax records linking 11 million businesses and their owners between 2001 and 2014, uncovered a surprising world of businesspeople who predominate in the top 1 percent of income. They are principals of white-collar, labor-intensive businesses such as law firms, consultancies, medical groups, and – at higher income levels – thousands of mid-sized enterprises like beverage distributorships and auto dealerships – each operating in one of hundreds of U.S. local areas.¹

We also determined that the income these entrepreneurs receive stems mainly from the work they perform and other contributions of their *human capital* – not from their businesses' physical and financial capital. Without their day-to-day labor and management, their networks of contacts, their ability to hire and retain staff, their professional reputations, and their personal brands, the revenue their business generate would collapse. In other

words, the top 1 percent earners in this country (not to be confused with top 1 percent wealth holders) mainly generate their high incomes from labor, not from the capital they hold.

There is a reason the human capital income of these top earners has not been fully recognized as such – it is hard to detect. At the top of the scale, entrepreneurial labor income often does not come in the form of a paycheck.

Rather, it is usually disguised as capital income accruing to the owners of two kinds of business entities: S-corporations² and partnerships, which are collectively known as “pass-through” businesses. These entities are described as pass-through because, in contrast with traditional forms of incorporation, their profits are not directly taxed by the corporate income tax. Instead, profits automatically pass through to the owners' tax returns where they are taxed at ordinary income tax rates and without any taxes on dividends.

Our research indicates that approximately three-quarters of pass-through business income received by the top 1 percent actually amounts to returns on the human capital their owners contribute to their enterprises.

Of course, entrepreneurs could simply pay themselves wages instead of profits. But most profit income carries a smaller tax burden than W-2 wage income by avoiding 4 percent in Medicare taxes, so tax liability is reduced when income is classified as profit. Working owners have considerable leeway in how to classify their income. Our work indicates that they have used that leeway to avoid taxes on their labor income. Stated plainly, most pass-through business income consists of wages cloaked as profits for tax purposes.

1 We focus on profits from the sale of goods and services, not from investment income such as in hedge funds and private equity firms.

2 S-corporations are the dominant form of top-owned pass-throughs. Like partnerships, they are private companies and taxed at the owner level. They are even more closely held than partnerships – often with only one or two owners – and their owners must be U.S. individuals, not foreigners or other businesses.

Analyzing Top Income

The finding that most pass-through profits — including S-corporation profits which official GDP calculations consider to be corporate profit just as much as publicly traded corporations' profit — is actually disguised labor income is counterintuitive and departs from much of the economic literature on inequality. That makes it especially important to lay out the data and the reasoning behind this conclusion. To estimate the sources of income for the top 1 percent in 2014, in addition to our own dataset linking 11 million pass-through businesses to their owners, we used the income distribution data series derived from tax records and other sources presented in Piketty, Saez and Zucman (2018) which allocates all of national income to individuals.

Among our findings:

- Pass-through profit income is widespread. Over 70 percent of the top 1 percent and 85 percent of the top 0.1 percent earned some pass-through business profit in 2014. This prevalence is all the more striking when one considers that pass-through profits do not include the capital gains, dividend, and interest income of hedge funds, private equity firms, and other investment vehicles.
- Total pass-through income received by top-1-percent owners is large: over \$1 trillion in 2014, representing one-third of all top-1-percent income. It exceeds non-owner wages, which is the category that includes the CEOs of public companies, and also exceeds other non-business forms of capital income, such as interest and stock dividends.
- When the three-quarters labor share of pass-through business income and direct W-2 wages are added, total labor income surpasses total capital income in the top 1 percent. At the person-level, a majority of top earners — even in the top 0.1 percent — earn most of their income from their human capital rather than their financial capital.

The conclusion that three-quarters of pass-through business income is from labor is central to our analysis. We arrived at this estimate by analyzing two natural experiments in which we measured the impact of owner death or retirement on profits, allowing us to observe the effect of withdrawing an owner's human capital from a business. In the first experiment, we examined Social Security records to identify working-age pass-through business owners who died between 2005 and 2010 and who had previously earned over \$1 million annually (a salient midpoint between the top 1 percent and top 0.1 percent thresholds). We found that an owner's death caused profits to plunge three-quarters on average.

In the second experiment, we examined pass-through businesses that stopped paying W-2 wages to an owner. We inferred that the owner had retired and was replaced by a non-owner manager. Profits at such businesses fell three-quarters on average following the owner's retirement. Thus, both the owner deaths and owner retirements analyses suggest that three-quarters of pass-through profits are returns to owner human capital.

The Significance for Tax Policy

In this Policy Brief, we have looked at evidence that hundreds of billions of dollars of income accruing to top earners as business income is actually labor income in disguise. Different people will have different views on what this finding should mean for tax policy. As a practical matter, policymakers typically try to equalize treatment of similar income, regardless of the form in which it is technically received. For example, a self-employed carpenter is legally obligated to pay the same income, Social Security, and Medicare taxes as an identical carpenter earning the same amount as a business employee. Our results highlight a failure of this equalization at the top of the income distribution.

Think of two car dealership CEOs: Alice and Betty. Alice is hired by the dealership owner. Betty is the dealership owner. Betty would likely have organized her dealership as an S-corporation and would likely be taking a majority

of her compensation as profits, frequently over \$1 million. Betty's profits will enjoy a 4-percentage-point lower tax rate, thanks to escaping Medicare taxes. An insight of this Policy Brief is that there are many thousands of owner-managers of mid-sized businesses like Betty and they constitute a large share of top earners.

To the extent that policymakers and voters want to tax labor income at high rates and want to give equal tax treatment to equals, additional regulations or a higher tax rate on S-corporation income would be necessary to treat Alice and Betty equally and to tax their labor income at the progressive rates that apply to W-2 wage income. The Tax Cuts and Jobs Act of 2017 made many changes to the taxation of pass-through income, including trying to erect guardrails that prevent even lower taxation of Betty's entrepreneurial labor income. However, nothing was done to equalize Alice's and Betty's tax treatments.

As a final note, readers may be surprised that an appropriate image of the typical million-dollar earner is an owner of a mid-sized business like a car dealership — rather than an idle heir to a large fortune or a technology mogul like Bill Gates. I will therefore leave you with the following memorable fact. All U.S. tax law originates from the representatives on the U.S. House Committee on Ways and Means. Three of its members are owners of car dealerships.

References

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Danny Yagan is a visiting fellow at SIEPR and an assistant professor of economics at the University of California, Berkeley. He teaches public sector economics and his

research uses large datasets and natural experiments to study U.S. tax policy, business investment, income inequality, upward mobility, and recession recovery.

Sam Zuckerman contributed editorial assistance to this Policy Brief.

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