Path to Prosperity

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Who Are Maine's "Rich?"

By J. Scott Moody
Chief Economist

In these dark economic times, the siren call of "tax the rich" is hurled at policymakers as the solution to Maine's budget woes. The accusation is that the rich are just sitting on their money and having government take it from them in order to spend it will get the economy moving again.

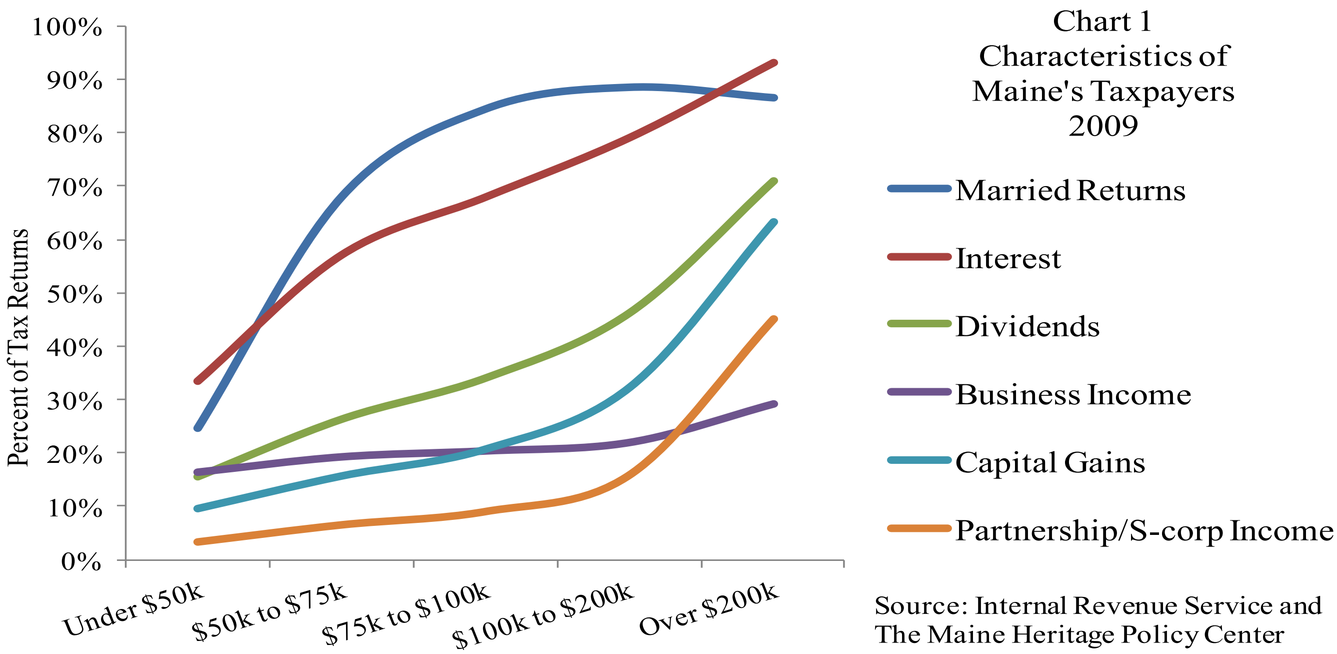
Of course, this caricature of the rich does not stand up to reality. This study analyzes data from the Internal Revenue Service for 2009 that shows the dramatic differences in the composition of income by various income groups.[1] Simply looking at total income can be misleading if one does not understand the underlying income dynamics because today's tax code includes a mish-mash of personal and business income. This study also provides an illustrative example of how this can happen.

The "Rich" are Overwhelmingly Married and Entrepreneurial

Chart 1 shows the various characteristics of Maine's taxpayers by income group as a percent of tax filers within each income group. The first item to note is how marriage affects the perception of "rich" versus "poor." For those earning under $50,000, the percent of married filers is 24.6 percent, but for those earning over $200,000 the percent of married filers is 86.6 percent.

This makes perfect sense since in today's economy where both husband and wife are in the workforce, marriage often results in a doubling of household income. A single person earning $40,000 would fall in the "under $50,000" category whereby a couple earning a combined $80,000 would show up in the "$75,000 to $100,000" category. By this metric, the married couple misleadingly looks better off economically than the single person.

The second item to note is that the percentage of taxpayers that have some kind of business income soars at the income levels over $200,000—93.2 percent of taxpayer have interest income, 71 percent of taxpayers have dividend income and 63.3 percent of taxpayers have capital gains income.



Source: Internal Revenue Service and The Maine Heritage Policy Center

More importantly, the percentage of taxpayers that have partnership/S-corporation income is dramatically higher for those earning over $200,000 (45.2 percent). This is almost three times as high as those earning between $100,000 and $200,000 (15.9 percent). The income from S-corps is particularly problematic because, unlike C-corps, S-corp income is taxed at the personal level. This pass-through income is not necessarily indicative of the taxpayers actual financial condition (see next section).

Along the same lines, the Tax Foundation published a booklet titled "Putting a Face on America's Tax Returns" which shows that "the vast majority of taxpayers who face the highest marginal tax rates [meaning high-income] tend to be married couples. But aside from being married, they also tend to be dual-income, residents of high-cost urban areas, older, college educated, and engaged in business activities."[2]

Graduated/Progressive Marginal Income Tax Rates Discriminate Against Entrepreneurs

For tax year 2011, Maine's had four tax rates: 2 percent, 4.5 percent, 7 percent and 8.5 percent. These increasing tax rates are called a "graduated" or "progressive" income tax rate system and can lead to all kinds of economic distortions. To see how, let's compare two hypothetical taxpayers—a single taxpayer with wages of $50,000 and a married couple (with two children) with combined wages of $100,000, S-corp income of $50,000, capital gains income of $20,000 and interest/dividend income of $5,000.

History of the S-Corporation:

In 1958, subchapter S of the tax code was enacted that created the modern S-corporation as we now know it. The primary reason for its creation was to eliminate the double-taxation of income that exists under traditional C-corporations.

For instance, dividends paid by a C-corp can only be paid out of after-tax income which is one layer of taxation. Individuals must then declare the dividends as income which results in two layers of taxation for the same stream of income. S-corps avoided this double-taxation by taxing business income only at the personal level.[3]

However, S-corps remained a small part of the corporate landscape until two major events that dramatically increased their desirability.

First, individual income tax rates were higher than corporate income tax rates until the Tax Reform Act of 1986 which dramatically lowered the individual tax rate to 28 percent. As a result, the popularity of S-corps increased significantly.

Secondly, the payroll tax rate for Social Security and Medicare topped 14 percent (combined employee and employer rate) for the first time in the mid-1980s. Unlike wages and salaries, S-corp dividends are not subject to payroll taxes which also boosts the popularity of S-corps over C-corps.

However, S-corps do have important limitations such as a restricted number of stockholders and types of stocks that can be issued. Nonetheless, as of 2007, S-corps represent 63 percent of all corporations in America.[4]

As shown in Table 1, taxes for the single taxpayer are straightforward and amounts to a tax bill of $2,842. As a percent of total and actual income (there is no difference for this taxpayer), this amounts to a tax burden of 5.7 percent.

The married couple's tax bill is not so simple. The problem stems from the S-corp income which is derived from a family-owned business that is in financial trouble. The business needs to make some necessary investments to stay competitive so, for the next few years, all profits will be retained to fund them. However, the profits must still be distributed to shareholders for taxation. So, this family's share of profits comes to $50,000 even though they won't actually receive $50,000—this is often referred to as "phantom income."

As a result of having to pay taxes on the S-corp income, the family will have to sell some stocks resulting in $20,000 worth of capital gains. They also receive $5,000 in interest and dividends from personal savings for college/retirement. The end result is that they will owe $12,413 in Maine income taxes.

Table 1
Hypothetical Taxpayers and Their Maine Personal Income Tax Bill
Calendar Year 2011

Single	Income	Married	Income
Wages	$50,000	Husband Wages	$50,000
		Wife Wages	$50,000
		S-Corporation	$50,000
		Capital Gains	$20,000
		Interest/Dividends	$5,000
Total Income	$50,000	Total Income	$175,000
Tax	$2,842		$12,413
Tax Burden as a Percent of ***Total*** Income	5.7%	Tax Burden as a Percent of ***Total*** Income	7.1%
Tax Burden as a Percent of ***Actual*** Income	5.7%	Tax Burden as a Percent of ***Actual*** Income	9.9%

Source: Maine Revenue Service and The Maine Heritage Policy Center

While on paper it looks like this family is better off than the single taxpayer, the single taxpayer is getting a much better tax deal with a tax burden on actual income of 5.7 percent. The family's income may be 3.5 times higher, but their tax bill is 4.4 times higher thanks to Maine's increasing marginal tax rates. Adding insult to injury, their overall tax burden is significantly higher, almost double the single taxpayer, at 9.9 percent of actual income—keep in mind that they never received the $50,000 from the S-corp which was kept by the business as retained earnings.

Conclusion

This simple illustration shows that the interplay between personal and business income within the tax code can lead to misleading conclusions about the actual financial condition of taxpayers. A "high-income" family with children and a business could be one step away from financial disaster while a "low-income" single taxpayer may be more stable and well-off.

As a result, comparing a taxpayers in the "under $50,000" income category with a taxpayer in the "over $200,000" income category is not an apples-to-apples comparison. Only 3.3 percent of taxpayers earning less than $50,000 have any partnership/S-corp income while 45.2 percent of all taxpayers earning more than $200,000 have partnership/S-corp income. It is absurd to compare the income of an individual with that of a doctor's office, yet that is exactly what is happening when using income tax data to make such comparison between aggregate income groups.

Notes and Sources:

[1] The IRS income tax data by state can be found here: http://www.irs.gov/taxstats/article/0,,id=171535,00.html

[2] Hodge, Scott A., "Putting a Face on America's Tax Returns," The Tax Foundation, 2005. http://taxfoundation.org/files/dba37618d9c2d2df02f24766ac4cc39d.pdf

[3] Nutter, Sarah E., Wilkie, Patrick J. and Young, James C., "Corporate Business Activity Before and After the Tax Reform Act of 1986," 1996 SOI Winter Bulletin. http://www.irs.gov/pub/irs-soi/86cobusact.pdf

[4] For more information, see SOI Bulletin Historical Table 21: http://www.irs.gov/taxstats/article/0,,id=175902,00.html

J. Scott Moody is chief economist at The Maine Heritage Policy Center. He may be reached at: jsmoody@mainepolicy.org

Path to Prosperity is a special series of publications by The Maine Heritage Policy Center which focus on Maine's overspending and the resulting tax burden that threaten long-term, stable and sustainable prosperity. All information is from sources considered reliable, but may be subject to inaccuracies, omissions, and modifications.

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Editor and director of communications, Peter Steele. He may be reached at: psteele@mainepolicy.org

P.O. Box 7829, Portland, ME 04112, Phone: 207.321.2550 Fax: 207.773.4385
http://www.mainepolicy.org
mainefreedomforum.com info@mainepolicy.org