Taxes Paid by High-Income Taxpayers and the Growth of Partnerships

By Susan Nelson*

Whether a tax system is judged to be fair depends, in part, on whether those citizens who are most able to pay taxes are perceived to pay a fair share of their income in taxes. Earlier analyses have focused on the extent to which taxpayers with high adjusted gross income (AGI) pay little or no tax. Such analyses are useful primarily in indicating the extent to which extraordinary itemized ("below-the-line") deductions reduce the tax liability of high-income taxpayers. But they do not shed much light on the extent to which taxpayers with substantial economic income are able to reduce AGI, and therefore taxable income and tax liability, with various "above-the-line" losses, including losses from tax shelters [1].

A computer analysis of all income tax returns for 1983 filed by high-income individuals provides further information on the tax burden borne by high-income taxpayers and on the commonly used means of lowering that burden. The analysis clearly identifies partnership losses as a primary source of offset to other income and thereby of reduction in tax liability for these high-income persons. Although the study does not measure the amount of tax reduction attributable to the specific tax incentives that provide opportunities for tax shelters, recent trends in the partnership sector suggest the growth and prevalence of tax shelter activity.

DEFINITION OF INCOME

It has long been recognized that losses allowed for tax purposes are often not real economic losses; frequently they are merely accounting losses that result from tax shelter activities. Because tax losses can offset normally taxable income, it is necessary in analyzing taxes paid by high-income groups to use a measure of income which is relatively unaffected by accounting losses that may not be real.

The measure of income chosen for this purpose is total positive income (TPI), which essentially equals the sum of (1) wages and salaries, (2) interest, (3) dividends, and (4) income from profitable businesses and investments [2]. Unlike the more commonly used measure of AGI, TPI does not subtract various exclusions or deductions which reduce AGI, such as Individual Retirement Arrangement (IRA) and self-employed retirement (Keogh) plan contributions and the 60 percent of long-term capital gains that is excluded from taxable income. TPI also excludes most business and investment losses which are taken into account in computing AGI.

Based on this definition of income, a return was classified as a high-income return if TPI was $250,000 or more. Since TPI excludes real losses as well as tax-shelter losses, it tends to overstate economic income; on the other hand, it understates economic income to the extent that tax-shelter losses offset economic gains within many activities. Nonetheless, most returns with positive income of $250,000 or more can reasonably be classified as "high income." For 1983, 260,000 tax returns (or 0.25 percent of all returns) reported TPI of $250,000 or more; nearly 28,000 tax returns reported TPI of $1 million or more.

INCOME TAXES

Many taxpayers with high positive incomes reported a substantial share of their income in taxes for 1983; nearly half (47 percent) owed at least 20 percent of their TPI in tax.

A significant minority, however, owed very low taxes, in spite of the current law minimum tax (see Figure A).

- Almost 30,000, or 11 percent of returns with TPI of $250,000 or more, reported virtually no tax; that is, taxes were less than 5 percent of TPI.

- Nearly twice as many owed no more than 10 percent of positive income in taxes. Fifty-five thousand, or 21 percent of all returns with positive incomes of $250,000 or more, reported 10 percent or less of

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positive income in taxes. Fifty-four hundred, or 19 percent of returns with TPI of $1 million or more, reported no more than 10 percent of positive income in taxes.

- Over 3,000, or 11 percent of returns with TPI of $1 million or more, showed virtually no tax.

Figure A.--Returns with Total Positive Income (TPI) of $250,000 or more, 1983

Item	Total Positive Income	
	$250,000 or more	$1 million or more
	(1)	(2)
All returns	260,275	27,796
Number of returns with income tax as a percent of TPI:		
Less than 5%	29,800	3,170
5% under 10%	25,452	2,225
10% under 20%	83,173	11,307
20% or more	121,850	11,094
Number of returns with:		
Partnership losses	166,401	19,871
Partnership losses exceeding 50% of TPI	12,655	1,600
Partnership losses exceeding TPI	1,916	306

These high-income taxpayers with less than 5 or 10 percent of TPI in taxes are shouldering lower tax burdens than typical taxpayers with substantially lower incomes.

- Upper-middle-income returns with TPI of between $30,000 and $75,000 showed, on the average, about 13 percent of positive income in taxes.

- Nearly 17,000 of the high-income returns with TPI of $250,000 or more owed less than $6,272 in tax, the amount that a typical four-person family with $45,000 of income owed. Fifteen hundred returns with TPI of $1 million or more showed less than this $6,272.

HOW TAXES WERE REDUCED

High-income returns with low tax liability relied most heavily on losses reported in current business activities, including those conducted in partnership form, to reduce their tax bills (see Figure B).

- Returns with TPI of $250,000 or more and taxes of less than 5 percent of TPI reported current business losses amounting, on the average, to 67 percent of TPI. (Thus, for example, a typical high-income return showing TPI of $300,000 might show losses of $200,000 and AGI of $100,000; taxable income would be even less, after allowance for itemized deductions and personal exemptions.)

The capital gains exclusion and losses carried over from previous years also offset large amounts of positive income for the low-tax returns. Itemized deductions (such as for state and local taxes, mortgage interest expenses, and charitable contributions) were much less important in reducing taxes.

- For the high-income, low-tax returns--those with taxes less than 5 percent of TPI--the combination of the capital gains exclusion and losses other than on current business activities offset 46 percent of TPI. (The combination of this exclusion and these losses, together with current business losses, offset more than 100 percent of TPI, on the average, for these returns.) "Excess" [3] itemized deductions offset only 18 percent of TPI.

The high-income returns with relatively high tax liability--those with taxes exceeding 20 percent of positive income--seem to have had more in common with the typical upper-middle-income return than with the high-income, low-tax return.

- "Above-the-line" offsets to TPI--primarily losses and the capital gains exclusion--were relatively unimportant for the high TPI returns with high taxes and for the upper-middle-income returns with TPI between $30,000 and $75,000. Current business losses averaged only 6 percent of TPI for the high-income, high-tax group and 4 percent of TPI for the moderate TPI returns. Capital gains exclusions and other losses offset an additional 11 percent and 6 percent of TPI for the two groups, respectively.

- For both the high-income, high-tax returns and for the upper-middle-income returns, itemized deductions--"below-the-line" offsets--were almost as important as all above-the-line offsets in reducing tax liability. Itemized deductions averaged 12 and 10 percent of TPI for the two groups, respectively.

For the high-income, low-tax returns, some of the current business losses that offset so much of positive income undoubtedly represented real economic losses. However, most of the losses came from partnerships. For some years,

Figure B.--Sources of Reductions to Income Subject to Tax as a Percent of Total Positive Income (TPI), 1983

Item	"Above-the-Line" Offsets to TPI			"Below-the-Line" Offsets to TPI		Tax after credits
	Current business losses[1]	All other losses and capital gains exclusion[2]	Total losses and capital gains exclusion	Excess itemized deductions	Investment and foreign tax credits	
	(1)	(2)	(3)	(4)	(5)	(6)
All high TPI returns ..	18.3%	23.2%	41.5%	13.6%	.8%	20.2%
Tax under 5% of TPI .	67.2	45.7	112.8	17.8	1.0	1.7
Tax 20% & over TPI .	5.8	10.7	16.5	11.6	.5	30.6
Upper-middle-income returns[3]............	4.4	6.1	10.5	9.9	.1	12.7

[1]Returns with $250,000 or more of TPI.
[2]Includes losses from partnerships; net losses from sole proprietorships (including farms), electing Small Business Corporations and rental and royalty properties; and net "supplemental losses" (from sales or exchanges of business assets and from involuntary conversions of assets). Includes primarily the excluded portion of capital gains plus net operating loss carryovers.
[3]Returns with $30,000 to $75,000 of TPI.

many partnerships have been utilized as vehicles for tax shelters (defined for purposes of this paper as activities producing net losses available to offset net income from other activities), and frequently they have registered accounting losses when they have incurred no real economic losses.

- o Among the 30,000 taxpayers with TPI of $250,000 or more who owed virtually no tax (i.e., tax of less than 5 percent of TPI), partnership losses alone offset an average of 36 percent of positive income.

- o Eighty-eight hundred, or 30 percent of taxpayers with TPI of $250,000 or more and tax liability below 5 percent of TPI, reported partnership losses equal to at least half of their positive incomes.

- o Approximately 1,900 high-income, low-tax returns had partnership losses which fully offset positive income.

THE GROWTH IN PARTNERSHIPS

The growth in tax shelter activity in recent years, particularly but not exclusively in limited partnerships, has been well advertised. Some figures help document that the growth in the partnership sector has been disproportionately concentrated in partnerships registering net tax losses, in limited partnerships which are the form of business most commonly used to provide tax shelters, and in industries that are accorded favorable tax treatment such as the real estate and oil and gas extraction industries (see Figure C) [4].

Historically, the partnership sector has been the source of substantial net income for individuals. For many years though, losses reported for tax purposes have been growing much faster than income, and individuals have recently reported more partnership losses than income.

- o For 1965, individuals reported almost nine times as much income from partnerships as they did losses--$11.1 billion in net profits versus $1.3 billion in net losses. By 1975, the ratio of reported income to reported loss had declined to 2.4 to 1--$18.4 billion versus $7.6 billion. By 1982, although net partnership income had reached $27.4 billion, net losses had risen dramatically to $28.3 billion, actually exceeding (positive) net income.

Growth in the partnership sector in recent years, much of it in the form of limited partnerships, has been concentrated in industries with favorable tax code treatment and therefore with opportunity for tax shelters.

- o From 1965 to 1975, the total number of partnerships increased by a modest 17 percent, from 914 thousand to almost 1.1 million. Between 1975 and 1982, forma-

Figure C.--Partnership Activity, 1965, 1975, and 1982

[All figures are estimates based on samples--money amounts are in millions of dollars]

Item and industry	1965	1975	1982
Partnership income reported on individual income tax returns by individuals:			
Net income	11,906	18,351	27,366
Net loss	1,354	7,600	28,274
Number of partnerships with and without net income:			
All industries	914,215	1,073,094	1,514,212
Oil and gas extraction	12,467	12,974	50,837
Real estate	192,833	320,878	562,575
Agriculture, forestry and fishing	127,782	123,173	132,394
Finance	44,537	106,595	147,676
Services	168,850	198,956	287,529
Number of partnerships with net income:			
All industries	684,822	661,134	791,117
Oil and gas extraction	6,934	7,214	21,686
Real estate	118,563	161,928	242,156
Agriculture, forestry and fishing	92,417	74,143	67,928
Finance	29,195	58,266	80,728
Services	137,774	138,510	180,153
Number of partnerships with net losses:			
All industries	229,393	411,960	723,095
Oil and gas extraction	5,533	5,760	29,151
Real estate	74,270	158,950	320,419
Agriculture, forestry and fishing	35,365	49,030	64,466
Finance	15,342	48,329	66,948
Services	31,076	60,446	107,376
Total net losses reported on partnership returns:			
All industries	1,569	14,694	60,871
Oil and gas extraction	128	1,657	13,220
Real estate	619	6,514	23,002
Agriculture, forestry and fishing	239	1,058	3,147
Finance	108	1,793	7,431
Services	158	1,877	6,750
Numbers of partners reported on partnership returns:			
All industries	2,721,899	4,950,634	9,764,667
Oil and gas extraction	n.a.	213,238	1,512,328
Real estate	674,489	1,549,716	3,720,805
Agriculture, forestry and fishing	322,147	351,062	448,623
Finance	317,187	1,422,954	1,983,132
Services	448,558	668,858	1,171,642

n.a. - Not available.

Source: Statistics of Income--Individual Income Tax Returns, selected years. Statistics of Income, Business Income Tax Returns, Statistics of Income--Partnership Returns and Statistics of Income Bulletin, selected years or issues.

NOTE: Net income or loss reported on partnership returns is after the deduction for guaranteed payments to partners. Income or loss reported by partners is the sum of partnership net income (or loss) and guaranteed payments to partners.

tion of partnerships accelerated, with the total number of partnerships rising by 41 percent from almost 1.1 million to 1.5 million.

- By comparison, from 1965 to 1975 the total number of partnerships in the two major tax-shelter industries, oil and gas extraction and real estate, rose by 63 percent, from 205,000 to almost 334,000. Partnership formation in these tax-shelter industries accelerated between 1975 and 1982, with the number of partnerships increasing by 84 percent to a little over 613,000.

- Between 1979 and 1982, 41 percent of the growth in all partnerships and 74 percent of the growth in the total number of partners occurred in limited partnerships.

The rapid growth in the number of partnerships reporting losses would lack a sound business rationale if it were not for the ability of many taxpayers to use the tax losses produced by these partnerships to shelter other income from taxation.

- Between 1965 and 1982, the number of partnerships with (positive) net income rose by only 16 percent, from 684,000 to 791,000.

- By comparison, the number of loss partnerships more than tripled during the same period: from 229,000 for 1965 to 723,000 for 1982.

Among partnerships with losses, the growth has been particularly rapid in two industries.

- Between 1965 and 1982, the number of partnerships reporting losses in the oil and gas extraction and real estate industries more than quadrupled. From 80,000 for 1965, the number doubled to 165,000 for 1975, and then more than doubled again to 350,000 by 1982.

While the statistics cited above indicate that tax-shelter activity has been growing rapidly, they say nothing about the importance of tax shelters in the overall economy and their distorting effect on the allocation of resources. Data from the Securities and Exchange Commission document that "tax shelters" have become a significant factor in the market for newly issued securities (see Figure D).

- In 1982 public offerings of tax shelter limited partnerships in oil and gas and in real estate equaled some $8.1 billion--almost 13 percent of all cash security offerings, and 31 percent of all cash equity offerings.

Figure D.--Limited Partnerships and Publicly-Offered Tax Shelters, 1979 and 1982

Item	Tax Year 1979	Tax Year 1982
	(1)	(2)
Number of Partnerships:		
All partnerships	1,299,493	1,514,212
Limited partnerships .	136,112	225,006
Number of partners:		
All partnerships	6,594,767	9,764,667
Limited partnerships .	2,352,378	4,710,080
New public offerings (billions):		
All cash offerings ...	$37.6	$63.7
Cash equity offerings	10.4	26.3
Tax shelter limited partnerships[1].......	2.3	8.1

[1]Public offerings of limited partnership interests in oil and gas drilling and real estate ventures which, in the opinion of the Securities and Exchange Commission (SEC) legal staff, promise significant benefits based on tax savings to the prospective investor and therefore are classified as tax shelters by the SEC.

Sources: Statistics of Income--Partnership Returns and Statistics of Income Bulletin, selected years or issues, and Securities and Exchange Commission (SEC), Registered Offering Statistics file. SEC data are actually for Calendar Years 1979 and 1982.

SUMMARY

Nearly half of the high income taxpayers for 1983 reported a substantial share of their income in taxes--47 percent reported taxes of at least 20 percent of their positive income. These high-income taxpayers made hardly any more use of special provisions of the tax code for reducing tax liability than did typical upper-middle-income taxpayers.

A significant minority of the high-income returns, however, showed virtually no tax. Nearly 30,000 (or 11 percent) of the returns with TPI of $250,000 or more reported no more than 5 percent of TPI in taxes. Over 3,000 (or 11 percent) of returns with $1 million or more in TPI reported virtually no tax. These high-income, low-tax returns look very different from both those of typical upper-middle-income taxpayers and those of high-income taxpayers who owe at least 20 percent of TPI in taxes.

The evidence discussed in this article supports the presumption that tax-shelter partnerships are an important vehicle for high-income individuals to reduce their tax liabilities. For the high-income returns examined that reported less than 5 percent of positive income in taxes, losses on current business activities--including sole proprietorships, farms, partnerships and rental and royalty properties--form the largest offset to positive income. Partnership losses are by far the largest component of current business losses.

DATA SOURCES AND LIMITATIONS

The data from individual income tax returns with TPI of $250,000 or more used for this analysis were obtained from two sources. One was a special extract, created for this purpose, from 1983 individual income tax return transaction files on computer tape. The transaction files are prepared by the Internal Revenue Service's ten service centers mainly for use as input to the centralized Individual Master File (IMF) of all taxpayers.

The information from the IMF system was supplemented by more detailed data from the Statistics of Income (SOI) sample of returns for 1983. This file is maintained as a data base by the Office of Tax Analysis in the Department of Treasury solely for use in tax policy research.

Data from the IMF system were based on all returns filed and, while subject to nonsampling error, are not subject to sampling error. To the extent that the data used in the analysis were from the SOI sample, however, sampling (as well as nonsampling) error is a limitation [5]. All of the data, whether from the IMF system or the SOI sample, were based on returns that had not yet been subjected to audit examination.

Data from partnership returns are from the SOI reports for the years cited and are also subject to sampling (and nonsampling) error.

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NOTES AND REFERENCES

[1] "Above-the-line" losses (or deductions) were those used in the computation of adjusted gross income (AGI). "Below-the-line" deductions were subtractions from AGI used to compute taxable (net) income (or subtractions from tax, i.e., tax credits, used to compute tax after credits).

[2] More specifically, total positive income (TPI) measures gross income reported on tax returns before losses. It primarily equals the sum of positive amounts of income on the Form 1040, with the following exceptions: for capital gains, it equals long- and short-term gains before losses and before exclusions; for Schedule E, TPI includes the income from rental and royalty properties with profits and the income from partnerships, from estates and trusts, and from Small Business Corporations (electing to be taxed through their shareholders) with net income. TPI is before subtraction of various exclusions or deductions which reduce AGI, such as Individual Retirement Arrangement (IRA) and self-employed retire- ment (Keogh) plan contributions, and the 60 percent exclusion of long-term capital gains.

[3] Excess itemized deductions was the amount, after reduction by the "zero bracket amount," used in computing taxable (net) income.

[4] For the more recent years, see also Piet, Patrick, "Partnership Returns, 1983," Statistics of Income Bulletin, Summer 1985 and "Partnership Returns, 1982," Statistics of Income Bulletin, Summer 1984.

[5] For information about the SOI sample and the sampling error associated with it, see Statistics of Income--1983, Individual Income Tax Returns, U.S. Department of the Treasury, Internal Revenue Service, 1985.