

Taxation of Top Incomes and Tax Avoidance

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Motivation

- Recent increase in concentration of income at the top led to proposals to significantly raise the top marginal income tax rate (Diamond and Saez, 2011). However, elasticity of taxable income (ETI) is high at the top (Mertens and Olea, 2018).
- Many top earners are business owners: 40% of the top 1% income is business income.
- Entrepreneurs can (1) report income as wage or profit to lower tax liability (2) choose pass-through business to avoid the double taxation on C-corporations.

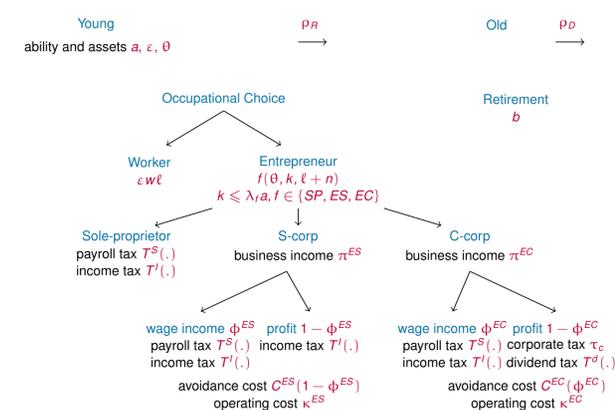
	Pass-Through		C-Corp.
	Sole-Prop.	S-Corp.	
Access to capital	difficult	easy	
Operating expenses	minimal	medium	high
Income Types	wage only	wage and profit	wage and profit
Tax on profit	-	income tax	corp. + dividend tax
Prevalence	67%	24%	9%

Research Questions

- How does tax avoidance affect tax revenue and productive efficiency?
- What are the aggregate and distributional consequences of an increase in the top marginal tax rate and in tax progressivity in the presence of tax avoidance?

Heterogeneous-Agent Model

- Agents have different working and entrepreneurial abilities (ε, θ) and asset levels (a).
- Occupational choice: Worker or Entrepreneur.
- Entrepreneurs choose to be sole-proprietors, S-corps, or C-corps.
- S- and C-corps owners choose to declare fraction ϕ of income as wage and the rest as profit.

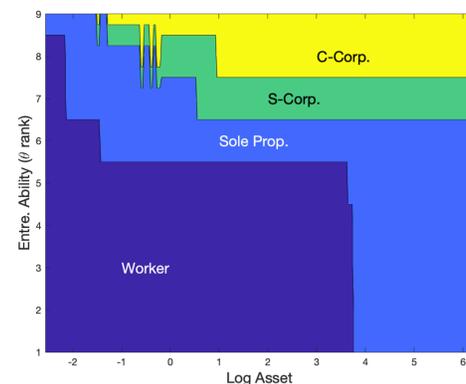


Calibration Result

Selected Parameters:

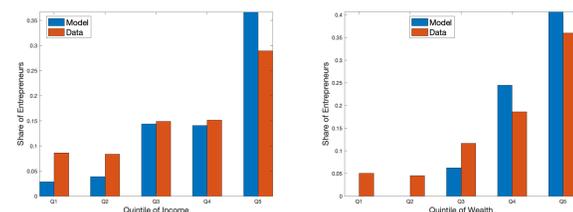
	Sole-Prop.	S-Corp.	C-Corp.
Collateral constraint λ	1.4	1.4	2.4
Operating cost κ	0	0.02	0.025
Avoidance cost $C^I(1)$	-	0.19	8

Optimal Occupation and Legal Form Choice



- Individuals with high entrepreneurial ability and high wealth choose to be entrepreneurs.
- Among entrepreneurs, those with the highest ability and wealth run C-corps.

Model Fit



- Higher concentration of entrepreneurs at the top of income and wealth distributions.

Reform 1: Eliminating Tax Avoidance

We consider two counterfactual scenarios:

- No intensive margin of tax avoidance:** S-corps are subject to the same tax treatment as sole-prop., and C-corps cannot report labor income.
- No tax avoidance on any margin:** All entrepreneurs are subject to the same tax treatment as sole-prop., i.e. pay income and payroll taxes.

	Benchmark	No Income Shifting (1)	No Tax Avoidance on all margins (2)
Share of Entre	0.144	0.148	0.171
<i>Dist. of LFO:</i>			
Sole-Prop.	0.667	0.889	0.316
S-Corp	0.231	-	-
C-corp	0.102	0.111	0.684
\mathbb{E} (Entre. Ability entre)	1.522	1.519	1.525
\mathbb{E} (Capital entre)	6.591	6.288	9.281
Ave. income	0.411	0.408	0.435
Tot. tax revenue	0.149	0.155	0.161

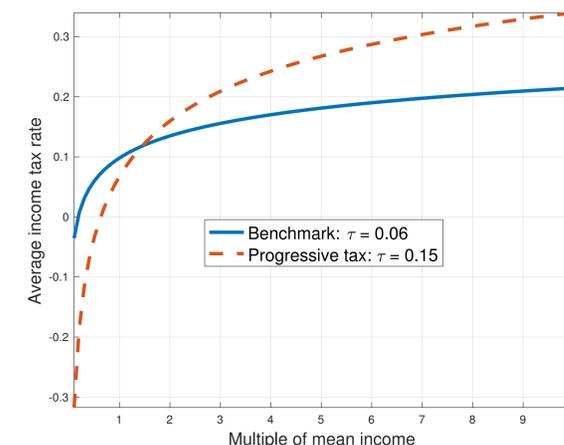
Summary

- Eliminating income shifting:** Small increase in tax revenue. S-corps become sole proprietors but no increase in the share of entrepreneurs. Little macroeconomic impact and small increase in tax revenue.
- Eliminating all tax avoidance:** More entrepreneurs and a greater share of C-corps. Significant improvement in average income due to easier access to capital as a result of more C-corps. Large increase in tax revenue.

Reform 2: Increasing Tax Progressivity

We consider a revenue-neutral increase in income tax progressivity under:

- the **benchmark economy** with tax avoidance, and
- the **no-tax-avoidance economy** (scenario 2), where all businesses pay income taxes.



	Benchmark Economy $\tau_{hsv} = 0.06$		No Tax Avoidance $\tau_{hsv} = 0.15$	
	(1)	(2)	(3)	(4)
<i>Inequality measures:</i>				
Gini Wealth	0.822	0.825	0.829	0.776
Top 1% Wealth Share	0.329	0.340	0.331	0.250
Gini Income	0.483	0.499	0.515	0.510
Top 1% Income Share	0.211	0.217	0.224	0.206
<i>Aggregate outcomes:</i>				
Ave. Income	0.411	0.398	0.435	0.407
Capital entre.	0.761	0.803	1.273	1.051
Share Entre.	0.144	0.149	0.171	0.196
<i>Dist. of legal forms:</i>				
Sole Prop.	0.667	0.698	0.316	0.309
S-Corp.	0.231	0.078	-	-
C-Corp.	0.102	0.224	0.684	0.691

Summary

- Increasing tax progressivity in the Benchmark economy:**
 - Entrepreneurs move from S-corps to C-corps to avoid the higher income taxes.
 - Slightly higher inequality!
 - More C-corps \Rightarrow more capital in the entrepreneurial sector but higher operating costs.
 - Average income goes down, suggesting a drop in economic efficiency.
- Increasing tax progressivity in the no-tax-avoidance economy:**
 - Little change in legal form distribution.
 - Significantly lower inequality but a drop in average income (economic efficiency) \Rightarrow equity-efficiency tradeoff.

Conclusions

- We build a heterogeneous agent model with choices of occupation and legal forms of businesses. Two margins of tax avoidance:
 - Intensive:** S- and C-corp owners can report income as labor or capital income to lower tax burden.
 - Extensive:** Entrepreneurs can choose to run pass-throughs to avoid double taxation of C-corps.
- Tax avoidance on the extensive margin lowers productive efficiency, and makes progressive taxation ineffective at lowering inequality.
- Next steps:**
 - Optimal top marginal tax rate with tax avoidance and optimal allocation of entrepreneurial talent across occupations and legal forms.

References

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