

## Effective Federal Income Tax Rates Faced by Small Businesses in the United States

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[75] pages. Under contract SBAHQ-07-Q-0012

Tax expenditures are a significant part of a business' s yearly expenses. Previous burden studies done by the Office of Advocacy have established that there are significant disproportionalities weighted against small businesses in the areas of regulatory and tax compliance. More specifically, compliance with tax regulations imposes costs that are 67 percent higher in small firms than in larger firms. Another aspect of this discussion is the tax rates paid by small businesses, which is the focus of the current research report.

The federal income tax system is based on progressive, graduated tax rates. The rate of tax paid increases on higher levels of income. As a result, the average rate levied on total income is not apparent. This research attempts to calculate the average effective tax rates faced by small businesses. The effective tax rate is defined as the actual percent of taxes paid by a firm on its net income. This average effective rate is useful for research purposes as a benchmark for comparison and to evaluate the effects of current and proposed policies.

This research explores how the effective tax rates on small businesses vary depending on legal form of organization, industrial classification, and business size. The report also examines the impact of special provisions in federal tax laws that apply only to small businesses and the impact of those provisions on effective tax rates. The report defines small businesses in a manner similar to the Internal Revenue Service, as firms with less than \$10 million in gross receipts.

### Overall Findings

While they are very widely referred to, the statutory tax rate does not represent the most useful measure of the effect of taxes on businesses. The effective tax rate captures the actual rate paid by businesses. The authors estimated that small businesses pay an average effective federal income tax rate of 19.8 percent.

### Highlights

- Small business sole proprietorships pay an average effective tax rate of 13.3 percent. Sole proprietors make up 84 percent of businesses with gross receipts of less than \$25,000 (13.5 million out of 15.9 million).
- The other kinds of small business entities face higher rates. Small business partnerships have an average effective tax rate of 23.6 percent, small S corporations have a rate of 26.9 percent, and small business C corporations have a rate of 17.5 percent. (The calculations for C corporations are conceptually different from those for other entity types and thus are not directly comparable with the other entities.)<sup>1</sup>
- Small partnerships, S and C corporations' higher effective tax rates are also a function of their relative size distribution. Small partnerships constitute 10 percent of small businesses with gross receipts between \$100,000 and \$250,000; small business S corporations constitute 23 percent of this size range;

<sup>1</sup> The rates computed for C corporations are not comparable to those borne by other forms of organization due to two key factors. First, existing data do not allow taxes on salary payments to be traced to the owners; and second, the data do not capture taxes paid on corporate income distributed to shareholders in the forms of dividends and capital gains.

and small C corporations constitute 13 percent of this group.

- Effective tax rates by industry group vary little among partnerships and S corporations. Among sole proprietors, the rate ranges from 4.1 percent for utilities (the smallest industry group represented) to 14.2 percent for wholesale and retail trade. Among C corporations, the rate ranges from 12.9 percent for agriculture to 27.1 percent for utilities (again, the smallest industry group represented).
- The effective federal income tax rate is one element of the overall tax burden, which also includes the Federal Insurance Contributions Act, or FICA, tax (which falls most heavily on the smaller entities), state and local taxes, and fees for permits and licenses.

#### **Average Effective Federal Income Tax Rates\* by Legal Form of Organization, 2004**

Entity Type	Effective Tax Rate
All Small Businesses	19.8%
Small Nonfarm Sole Proprietorships	13.3%
Small Partnerships	23.6%
Small S Corporations	26.9%
Small C Corporations†	17.5%

Source: Quantria Strategies LLC

\*The effective tax rate is the amount of taxes paid by a firm as a percent of its net income.

†The C corporation tax rate is not directly comparable to other rates. See footnote 1 for details.

#### **Scope and Methodology**

Average effective tax rates can provide a useful measure of whether firms in similar circumstances pay approximately the same level of tax. The principal data source is a sample of individual federal income tax returns representative of all individual returns filed in 2004, the most recent year for which firm level data are available. The Individual Statistics of Income, Public Use File (PUF) is an annual, micro-level data file constructed from a stratified, random sample of approximately 150,000 U.S. taxpayers.

This study relies on microsimulation to calculate the effective tax rates of small businesses in the U.S. For more than thirty years, microsimulation has been a workhorse of tax policy analysis. In this modeling approach, aggregate outcomes are simulated from the “bottom-up,” by focusing on the micro-level components of the tax system (e.g., individuals or businesses).

In microsimulation, federal income taxes are simulated for each taxpayer by means of a very detailed tax calculator that incorporates the parameters and features of the current tax law. Quite often, the analyst is also interested in how a change in one or more aspects of existing tax law may affect revenues or the distribution of income taxes. This counterfactual simulation is then compared with estimates of tax liabilities under the original or baseline simulation.

This report was peer reviewed consistent with the Office of Advocacy’s data quality guidelines. More information on this process can be obtained by contacting the director of economic research at [advocacy@sba.gov](mailto:advocacy@sba.gov) or (202) 205-6533.

#### **Ordering Information**

The full text of this report and summaries of other studies performed under contract with the U.S. Small Business Administration’s Office of Advocacy are available on the Internet at [www.sba.gov/advoresearch](http://www.sba.gov/advoresearch). Copies are available for purchase from:

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