ENTITY CHOICE AND EFFECTIVE TAX RATES

EXECUTIVE SUMMARY

Several years ago, under contract with the Small Business Administration, Quantria Strategies, LLC measured effective tax rates for small businesses by entity type. This effort to measure effective tax rates by business type was the first of its kind and it produced what was, for us, an unexpected finding – that S corporations had the highest effective tax rate of any entity type with gross receipts less than $10 million.

Overall, the 2009 study found that small business sole proprietorships faced the lowest average effective tax rate at 13.3 percent. Small business partnerships faced an average effective tax rate of 23.6 percent, small business C corporations faced a 17.5 percent average effective tax rate, and small business S corporations faced an average effective tax rate of 26.9 percent.[1]

While many people think of the statutory tax rate when they consider the effect of federal income taxes, the reality is that the statutory tax rate does not represent the best measure of the effect of taxes on a business. Average effective tax rates are a better measure of whether a particular industry or business form faces greater or lesser federal income taxes relative to other industries or business forms.

Since release of that study, two significant tax policy changes occurred. First, adoption of the Patient Protection and Affordable Care Act imposed a new 3.8 percent tax on investment income (including some pass-through income) beginning 2013.[2]

Second, resolution of the fiscal cliff debate earlier this year subsequently increased the top individual marginal tax rates in two ways. The top statutory tax rate that applies to individual and pass-through business income increased from 35 percent to 39.6 percent, while the reinstatement of the Pease limitation on itemized deductions had the effect of raising top marginal tax rates by another 1.3 percent.[3]

Because of these changes, for the first time since 2002 the top marginal tax rate that applies to individuals and pass-through businesses is significantly higher (44.7 percent) than the top marginal tax rate that applies to C corporations (35 percent).

This study is an update to our previous work and estimates the impact of those federal income tax changes on the effective tax rates of all businesses.

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[1] These calculations include only those entities with positive net income for the 2004 tax year.

[2] Our estimates distinguish between the types of income that are subject to the tax on investment income. In general, investment income include: interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities, and businesses that are *passive activities to the taxpayer* (defined in section 469 of the Internal Revenue Code).

[3] Refer to Robert Carroll and Gerald Prante, *Long-run macroeconomic impact of increasing tax rates on high-income taxpayers in 2013*, July 2012.

As such, the study includes three key distinctions from that earlier study. First, we consider all businesses – not just those with less than $10 million in gross receipts. Second, our effective tax rate estimates include the tax rates in effect for 2013, including the increase in the highest individual marginal tax rate from 35 to 39.6 percent, the new 3.8 percent tax on additional investment income, and the Pease phase-out of deductions for high-income taxpayers. Third, while our previous study did not include the second layer of tax paid by C corporations, this study does include the effect of corporate dividends paid on the effective tax rates of C corporations.

Considering these changes, our results remain consistent with the previous study, finding that S corporations once again face the highest effective tax rates.

Effective Tax Rate Summary, by Entity Type, 2013
(Dollars in Millions)

Entity Type	Number of Taxpayers†	Net Income	Effective Tax Rate
S Corporations	3,879,976	393,168.4	31.6%
Partnerships	2,833,699	226,427.4	29.4%
C Corporations	814,837	1,778,597.1	17.8%
Non-Farm Sole Proprietorships	21,978,470	425,399.1	15.1%

Source: Quantria Strategies, LLC Individual Income Tax Simulation Model, 2013 and IRS Corporate Source Book, 2010
†Consistent with most studies that measure effective tax rates, these calculations include only businesses with positive net income.

To calculate effective tax rates, the study uses tax rather than book data. For the numerator, the study uses actual taxes paid or accrued for the current period, including taxes paid to foreign jurisdictions, while the denominator is net income reported on tax returns (before statutory deductions) less state taxes paid. The calculations use worldwide income and include only those businesses reporting positive income for the period.[4]

[4] For comparison purposes, we also calculated the estimated effective tax rates for C corporations without consideration of foreign earnings and the foreign tax credit. This measure provides an alternative view of the average effective tax rates, indicating that C corporations have an average effective tax rate from domestic sources of 27.1 percent. Refer to Appendix B for a fuller explanation of the C corporation calculations.