

# Business Legal Entities and Tax Rates

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One of the most frequently asked questions (FAQs) I receive from pre-venture clients concerns the legal entity of their prospective business. I always preface my remarks in regards to this query with “ultimately you must consult with your attorney and accountant.” I then show them a standard chart that breaks down various legal structures ranging from Sole Proprietor to S Corp.

Obviously there are a number of factors to consider when choosing the legal structure for any new business or reassessing an established business. Taxes however tend to be the pre-venture client’s first concern when this issue is discussed. A recently released study done by “Quantria Strategies” through funding from the “Office of the Advocacy of the Small Business Administration” provided some eye-opening information that is certainly worth a look by both pre-venture and established entrepreneurs.

In 2004, the overall average “effective tax rate” on small businesses (under \$10 million in annual gross receipts) was 19.8%. Keep in mind that the *“effective federal income tax rate” is the actual amount of taxes paid by a firm as a percent of its net income.* We all know that exceptions to the normal “statutory tax” rates such as deductions, exclusions, and credits have the effect of lowering the tax rates paid by firms. The result is a difference between the “statutory rate” and the actual or “effective rate” paid by the business or its owners.

Of all sole proprietorships only 3.1% report a net income of \$100,000 while 60% have a net income of less than \$10,000 and the “effective tax rate” is 13.3%. S Corps on the other hand have an “effective tax rate” of 26.9%, but 18% have net incomes in excess of \$100,000. In contrast, small partnership rates were 23.6% and while not directly comparable, C Corp rates were 17.5%.

Naturally smaller firms are taxed at a lower “statutory rate” but these are interesting findings none the less. Since the tax season has passed for most of us, and if for no other reason than curiosity, you might want to see what your effective tax rate was for 2008 and how you compare to the national average if you are an established business. For aspiring entrepreneurs this is one more reason to fully investigate your options before designating the legal entity of your new enterprise. As we always say, “consult your attorney and your accountant” before you make this very critical decision.

(To access the complete study click here [www.sba.gov/advo/april09.pdf](http://www.sba.gov/advo/april09.pdf) )