To avoid tax, set up as S-Corp or C-Corp?
Karen E. Klein

Most small businesses are structured as S-corporations. But some are considering C-corp status because of worries about tax hikes in 2011.

The debate on proposed tax rate increases for the country's wealthiest people has just begun, and the potential increases would not happen until 2011. Still, tax experts say it is not too early for small business owners to think about defensive strategies. Whether they're contemplating moving from S-corporation to C-corporation status, accelerating income, or deferring compensation, their decisions should be thought through in the larger context of their business and personal goals, says Lester Law, senior vice president at U.S. Trust's National Wealth Strategies Group(BAC), in Naples, Fla. He spoke recently to Smart Answers columnist Karen E. Klein; edited excerpts of their conversation follow.

Under President Obama's proposed 2011 budget, there's a tax cut for middle-class taxpayers. But the tax cuts that George Bush enacted on upper-income taxpayers would be allowed to expire at the end of 2010 as scheduled. That means individuals currently taxed at 33% would be taxed at 36% and those taxed now at 35% would be taxed at 39.6%. How likely is it that those rate increases will become law?

Right now, we're in a holding pattern. But we anticipate, based upon what has been put out there by the President and the Congress, that we will have a higher income tax for certain individuals. There are a number of bills that have been proposed that include those increases, and the Treasury has refined that budget in its so-called Green Book published this month.

The important thing to remember is that most of the changes wouldn't occur until 2011. Small business owners who think they might be affected really need to see their tax advisers and look at their long-term desires, not just for their businesses but also for their personal needs. They need to run the numbers; this should not be a gut reaction.

What's the danger of doing something reactive in anticipation of higher tax rates?

If I said you can buy today a widget at $10 or you can buy a widget in two years for $20, your gut reaction might be to buy it now at $10. But what if I also told you that you could invest that $10 and grow it to $40? You might wait. But what if you really need the widget today?

It's important to figure out what all the needs, facts, and desires are. Just to say there might be higher taxes, so we ought to do something, that's not the smart way to do things.

What are some of the strategies you're exploring now with clients?

At first blush, the idea would be that if tax rates are going to go higher in the future, maybe we ought to recognize income in the early years, while rates are down, rather than in later years when the tax rates go up. So accelerating income is one possibility we're looking at, weighing factors such as the time horizon for holding the income or recognizing the asset, the potential for more increases in tax rates and what the growth of that particular asset or income will be in the future.

Another discussion is about whether to defer compensation for small business owners nearing retirement, especially for executives participating in non-qualified deferred-compensation plans such as non-401(k) or IRA retirement plans.

Most small businesses are organized as S-corporations, which is generally more advantageous for tax purposes. But S-corp profits get passed through into the owners' personal income tax

returns and may push them into higher tax brackets, even though they're not taking extremely large salaries. Is there any discussion about converting some of the most successful businesses to C-corporations?

Yes, we do have clients that are considering terminating their S-corp election, and we have some that were contemplating going from C-corp to S-corp, and they're revisiting their assumptions.

What's involved in terminating the S-corp election? Is it a costly, complicated process?

Not too much. There is some additional income tax reporting work by the shareholders and the accountants. If you do it in the middle of the year, you'll effectively have to file two different tax returns.

The larger picture is that if you lose your S-election, there's a rule that says you can't go back to being an S-corp for five years, though there are some exceptions. But if you do it and later realize that being a C-corp is less beneficial than you thought, you can't just say: "Well, I'll go back tomorrow."

One of the downsides of the C-corp is the issue of double taxation. How does that work?

Let's say your C-corporation earns $100 and is taxed at the highest corporate tax rate of 35%. That leaves $65 after taxes are paid. Let's say the business owner needs that $65, so it comes out of the corporation as a dividend and the owner reports it and is taxed at 20%, which is the anticipated dividend tax rate. So another $13 in tax is paid and the business owner nets $52.

With an S-corp that earns $100, it's reported on the business owner's individual tax return and if he's in the highest bracket it's taxed at 40% and the owner nets $60. There are a whole bunch of other taxes, including state taxes and self-employment taxes, that may shift those numbers but that gives you a simple example of how the double tax could still be higher at the anticipated future tax rates.

What are some of the other details you're considering when it comes to S-corporations versus C-corporations?

State taxes are very important because in some states there is no personal state income tax but there is a state corporate tax. Also the nature of the assets inside the S-corporation and the type of income that comes out is important.

And the other thing is that the federal corporate tax rate now starts off at 15% and at the higher income levels you're looking at about 35%. But what we don't know is whether we'll have higher tax rates for corporations in the future. We may make a decision now based on today's rates but in the long term if corporate tax rates change then we could find out we've actually done something that will have a negative impact.

This is why I say that small business owners who are concerned about the potential for higher tax rates should run the numbers with their advisers and go through alternate scenarios that look at the long-term health of the business and the individual owners.

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