

# Small Business Owners Need to Plan for Tax Increases in 2011



One of the advantages to operating as an S Corporation is that the corporation's income is passed through to its shareholders, similar to a partnership or sole proprietorship. However, anticipated tax increases in 2011 may negate some of the advantages to operating as an S Corporation. In certain circumstances, once the increases take effect, it may be more advantageous to operate as a C Corporation. Certain tax cuts, enacted by former President George W. Bush are scheduled to expire at the end of the 2010 calendar year. President Obama's proposed budget for 2011 does not contemplate an extension or renewal for these tax cuts, which primarily benefit upper class taxpayers. Assuming that these tax cuts are not extended or renewed, beginning in 2011, taxpayers who are currently being taxed at 33% will be taxed at 36% and taxpayers who are currently being taxed at 35% will be taxed at 39.6%.

President Obama's proposed budget provides that the 36% bracket would apply to individuals earning taxable income in excess of \$190,650 or in excess of \$231,300 for married taxpayers filing jointly. The proposed budget does not currently specify the taxable income break points for the proposed 39.6% bracket; however, tax experts anticipate that it will remain around the current threshold of \$372,950.

Small business owners who operate under a pass-through entity, such as an S Corporation, are affected by the 2011 tax code changes, since they will be paying income taxes on the corporation's income, whether or not it was distributed to them. These individuals should meet with their tax advisors to explore strategies that may be available to minimize the impact of these changes.

One potential strategy for certain small business owners is to consider converting from an S Corporation to a C Corporation. An S Corporation, as a pass-through entity, elects a special tax status with the Internal Revenue Service, where the corporation's income is passed-through to its shareholders, much like a partnership or sole proprietorship. Each shareholder then reports the respective income or losses on their individual tax returns, whether or not the corporation's profits were actually distributed to the shareholder. The corporation itself, does not pay taxes.

In contrast, in a C Corporation, the corporation does pay taxes on the corporation's profits. The individual shareholders do not pay taxes on the corporation's profits, unless such profits were actually distributed to the shareholders through salaries, dividends, and bonuses or otherwise. This potential for "double-taxation", where income is being taxed at both the corporate and personal taxpayer level is a

primary reason why a small business owner would elect to operate as an S Corporation.

Beginning in 2011, S Corporation shareholders may be required to pay a higher income tax rate for income that is not being distributed to the shareholders, but rather being retained in the corporation. In other words, certain shareholders may be paying up to 39.6% of personal income tax on income that is being retained by the corporation and not distributed to the shareholders. If a business anticipates that in the long-term, it will allow the corporation to retain significant profits, rather than distribute such profits to the shareholders, then it may benefit from converting to a C Corporation. However, this type of decision should not be considered lightly and without input from your tax advisors. Any tax benefit received by the conversion to a C Corporation may be outweighed by some of the other considerable disadvantages to operating as a C Corporation.

As mentioned above, most tax professionals see the major disadvantage of a C Corporation is that of double taxation. A C Corporation must pay income taxes based on its net income at corporation rates. Subsequent dividends and other distributions that are received by the shareholders are then taxed to the shareholder at individual rates. This amounts to double taxation, with the same profits being taxed at both the corporate and personal levels.

An S Corporation's net operating losses and tax credits are passed directly to the shareholder that the shareholder may use on their individual tax return subject to various limitations. The corporation retains a C Corporation's net operating losses and tax credits. The unused net operating losses of the C Corporation can either be carried back or carried forward to offset income in profitable years. There is no transfer of these net operating losses or tax credits to the shareholders. This can be a disadvantage to converting to a C Corporation if a shareholder needs the losses and tax credits to reduce their individual tax liability.

Capital losses generated by a C Corporation can only be used to offset capital gains, never ordinary income. Any excess capital losses can be carried back for three years and forward for five years to offset capital gains in the carryover years. If the capital loss carryover is not utilized within the carryover periods, it is lost. This treatment is a disadvantage when compared to the treatment of capital losses of an S Corporation. Capital losses of an S Corporation are passed through to the shareholders. The shareholders can then use the capital loss to offset any capital gains and up to \$3,000 of ordinary income annually. Any unused portion of the capital loss is then carried forward until it is exhausted.

There is also different tax treatment for charitable contributions. Charitable contributions made by an S Corporation flow through to each individual shareholder. S Corporation shareholders who itemize can claim the charitable contribution as a deduction, subject to limitations, on his individual return. Charitable contributions made by a C Corporation are deducted on the C Corporation return with no pass through to the individual shareholders. Charitable contributions for a specific year are limited to 10 percent of taxable income before certain deductions. Any unused charitable contributions of the C Corporation may be carried over for five tax years.

Under the current tax laws, the C Corporation federal tax rates range from 15% for corporations with taxable income less than \$50,000 up to 35% for corporations with taxable income over \$10,000,000. There is a 3% increase in the C Corporation tax rate for taxable income between \$15,000,000 and \$18,333,333. S Corporation income that is passed through to shareholders would be taxed at individual federal rates, which range from 10% to 35%, with expected increases up to 39.6% in 2011. The income levels taxed at each rate vary depending on the filing status of the shareholder. In the current economic climate, the federal government, along with most states, is underfunded and is looking for ways to generate income. Increasing taxes on corporations may be seen by governments as a more favorable alternative to increasing taxes on individuals. Even though no announcements have been made to raise the corporate tax rates, there is always the possibility that the corporate tax rates may increase. If the corporation tax rates do increase, the increases could nullify any advantages to converting to a C Corporation and could make it even more expensive to be a C Corporation.

Converting from an S Corporation to a C Corporation carries the requirement that you cannot convert back to an S Corporation for at least five years. Therefore, if corporate or individual tax rates change or other circumstances occur to make it more beneficial for the corporation to be treated as an S Corporation as opposed to a

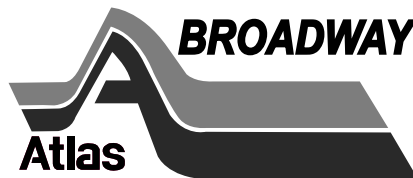
C Corporation, the corporation cannot make an S Corporation election within the five year window. Also, if the corporation converts back to an S Corporation, the S Corporation will be required to have a December 31 tax year-end.

A conversion from an S Corporation to a C Corporation may be an appropriate strategy for small business owners to minimize the impact of the 2011 tax increases. However, a decision to convert from an S Corporation to a C Corporation must be carefully examined with your tax advisors. Any advan-

tages realized from converting from an S Corporation to a C Corporation, may be outweighed by the disadvantages that can arise from such a conversion. *Adam Siegelheim is a member of Stark & Stark's corporate and franchise group. He can be reached at 609-896-9060 or [Asiegelheim@stark-stark.com](mailto:Asiegelheim@stark-stark.com). Susan M. Shaffer is an associate in the tax & consulting group of the Mercadien Group. She can be reached at 609-689-2337 or [Sshaffer@Mercadien.com](mailto:Sshaffer@Mercadien.com).*

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