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Firms Puzzle Over Tax Riddle

By EMILY MALTBY
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Business owners can't change the tax code, but many of them say they might change the way their businesses are structured in order to pay less tax.

Chris Pullen of Fort Collins, Colo., is grappling with whether to convert his growing business into a so-called C-Corporation, as a potential tax-savings move.

"The more taxes we pay, the less we have to reinvest,' says RLE Technologies co-owner Chris Pullen, above. *Benjamin Rasmussen for The Wall Street Journal*

Mr. Pullen, president of 20-employee RLE Technologies, is among the nearly 30 million business owners who include their business profits on their personal income-tax returns. Changing the company to a C-Corporation would let him pay corporate taxes separately from his personal taxes.

RLE, which makes sensors that monitor data centers, hospitals and other facilities for temperature, humidity and water leaks, had more than $5 million in revenue last year. It is structured as an S-Corporation, which means its profits "flow through" to its owners, who pay taxes on that money at personal tax rates.

"The more taxes we pay, the less we have to reinvest," says the 54-year-old Mr. Pullen, who became a part-owner of the company last year.

He says RLE's five shareholders generally take $100,000-a-year salaries. But claiming their share of business profits drives their collective taxable income several hundred thousand dollars higher—even though most profits go back into the business to pay for new employees or equipment.

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This year personal income-tax rates for the highest earners—single filers exceeding $400,000 and joint filers exceeding $450,000—rose to 39.6% from 35% in 2012. The problem for shareholders of RLE, which has 12% annual revenue growth, is that the business could be bringing in enough profit within a few years to bump them into the highest tax bracket.

The top corporate-tax rate, by contrast, is 35%, though it might decline if Congress overhauls corporate taxes. President Barack Obama called for a cut in business-tax rates in his State of the Union speech last week, and has previously proposed eliminating loopholes and subsidies in order to reduce the highest corporate-tax rate to 28%. Such a move would make switching to a C-Corporation structure "even more appealing," Mr. Pullen says.

Lowering taxes is a top priority for business owners this year, especially in light of the higher individual tax rates. Tax worries are "right up there with health care, cash-flow concerns, debt obligations and financing" as big problem areas for U.S. small business this year, says Scott Berger, tax principal at the accounting firm Kaufman, Rossin & Co. in Boca Raton, Fla.

Thirty-five percent of 848 small-business owners and chiefs surveyed by The Wall Street Journal and Vistage International, a peer-advisory firm for CEOs and senior executives, said they would consider reorganizing into C-Corporations if corporate-tax rates were cut.

The survey, conducted online Feb. 4-13, included businesses in manufacturing, construction, retailing and other industries with annual revenue between $1 million and $20 million.

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Larger companies are commonly organized as C-Corporations. Unlike S-Corporations, the structure allows for multiple classes of stock and an unrestricted number of shareholders.

Massis Chahbazian, 50, president and chief executive of Printery Inc. in Irvine, Calif., says he would "consider changing over" to a C-Corporation if the corporate-tax rate were cut. His digital printing firm, an S-Corporation, has 30 workers. He eventually plans to sell the firm to fund his retirement. Retirement planning also will influence his decision about its structure, he says.

David Gracey, 45, expects to be in the highest personal tax bracket this year. He runs Network 1 Consulting, an information-technology outsourcing business in Atlanta, as an S-Corporation. After he files his 2012 taxes, he says, he plans to consult his accountant about switching to a C-Corporation. "All options are on the table," he adds.

Ninety-five percent of all business entities declare business profits on their owners' personal tax returns, according to an August 2012 report from Congress's Joint Committee on Taxation. Some experts say C-Corporations may not significantly lower these business owners' tax bills—and might raise their tax burden.

"Even though on the surface you're looking at 35% versus 39.6%, it's a deceptive comparison," says Robert W. Wood, a tax lawyer with Wood LLP in San Francisco. "There may be a slight short-term advantage in C-Corporations, but there are a number of negative long-term implications that would outweigh short-term benefit."

For example, C-Corporation profits can be double-taxed. In addition to the corporate tax on profits, owners also would owe personal taxes on any money they take out of the company as dividends. The double tax kicks in when a business is sold, too.

Another potential problem is that a firm that switches from an S-Corporation generally has to remain a C-Corporation for at least five years.

Carol Piccaro, 54, is CEO of U.S. Chemicals LLC in Darien, Conn., a chemical-distribution firm her father founded in 1960. It started out as a C-Corporation, but she changed it to an LLC about 15 years ago for estate-planning reasons. The move was designed to reduce her tax burden when the company is sold.

Ms. Piccaro says she has no intention of going back to a C-Corporation, even if corporate tax rates do go down, in part because the costs in time and money to make the switch might offset any tax savings.In the survey, 29% said they wouldn't consider reorganizing into C-Corporations, even if corporate tax rates fell.

Write to Emily Maltby at emily.maltby@wsj.com