Here's A $10 Million Tax Question: C or S Corporation?

The massive tax law passed by Congress and President Trump at the end of 2017 radically reshaped traditional tax planning in ways that are still emerging. A prime example is choice of entity for small and not-so-small businesses. There are still the usual suspects, corporations, partnerships and limited liability companies (LLCs), but many tax incentives have changed. A few decades ago, when an individual outgrew a proprietorship, a corporation was almost always the logical choice. In more recent decades, LLCs became the new norm. They are generally taxed as partnerships.

That means partners (or using the terminology of LLCs, ‘members’) pay taxes on the business income themselves at their *own* tax rates.

Flow-through tax treatment is still favored, but now even more so. The new 20% pass-through tax deduction has generated enormous interest, and complexity. The IRS rules about this deduction are here: Tax Cuts and Jobs Act, Provision 11011 Section 199A.

Essentially, if you earn less than certain amounts, you can deduct 20% of the income from pass-through businesses. There are many technical rules, though, and special rules for service professionals. Suffice it to say that flow through entities like partnerships, LLCs, and S corporations got a big boost from the new law.

But if you have a corporation—one that you formed or inherited—should it be an S or a C corporation?

If you think flow-through, you might assume S, but what does this alphabet soup of corporate tax status really *mean*? Articles of Incorporation filed with your state’s Secretary of State are the corporation’s birth certificate.

However, these articles do not say if the corporation is an S or a C. All corporations are C corporations unless they file for S corporation status. If you take no action to elect S corporation tax treatment from the IRS, your corporation is a C corporation.

Both S and C corporations are entitled to limited liability. Limited liability is a traditional reason businesses incorporate (although LLCs are *also* entitled to limited liability).

A corporation is understandable, a separate legal entity, owned by shareholders, ruled by a board of directors, who elect officers to do day-to-day management. But C vs. S status is all about taxes.

If you file a one page S election with the IRS, the corporation will be taxed almost like a partnership or LLC. And subject to limits, you can change your corporate status.

A corporation can be a C corporation for many years, then change to S status. There are special rules and limits on converting from S to C, and vice versa. If you change too soon or too frequently, you must ask the IRS for permission. Also, the tax code imposes a kind of hybrid corporate tax on S corporations that convert from C status.

By filing an S election upon the initial formation of the corporation (generally in the first 75 days of the corporation's formation), it will *never* be a C corporation. That way, the company and its shareholders do not need to worry about the built-in gain tax that can apply to conversions from C to S. You can avoid that complication if the corporation files S status from the beginning.

After all, income from a C corporation is taxed twice. The corporation pays tax on its net income. Then, shareholders also pay tax on dividend distributions they receive. In contrast, income from an S corporation is taxed once at the shareholder level. Starting in 2018, the tax law radically cut the corporate tax rate paid by C corporations from 35% to 21%.

That means C corporation status is much better, right? Well, compare that 21% rate to how an S corporation is taxed. Individual tax rates were also cut. The top rate dropped from 39.6% to 37%.

Then there's the pass-through deduction. If you qualify, it can reduce the top effective tax rate from 37% to 29.6%. For many, the idea of a 29.6% tax rate sounds pretty good, even compared to the 21% C corporation tax rate.

With a C corporation, one must consider the shareholder level taxes too. Dividends are generally taxed at 15% or 20%, depending on income levels. Considering the corporate tax and the shareholder tax, unless you leave all income in the corporation, you end up paying more in taxes with a C corporation, even at the 21% corporate rate. What can be a $10M issue?

Consider Qualified Small Business Stock (QSBS) treatment, which only applies to C corporation stock. For the small companies that qualify—generally up to $50 million in assets—shareholders who have held their stock for 5 years may be able to exclude their gain from federal tax. The shareholder limit is usually $10 million, and $10 million tax free would be nice! If you sell QUALIFIED SMALL BUSINESS STOCK but have not held it for 5 years, there is another QUALIFIED SMALL BUSINESS STOCK benefit.

You can defer the gain by rolling it over into a new investment in QUALIFIED SMALL BUSINESS STOCK. All in all, the QUALIFIED SMALL BUSINESS STOCK rules can allow founders and other shareholders huge tax free or tax deferred benefits.

If you still like S status, remember that there are eligibility rules. An S corporation can have no more than 100 shareholders, only U.S. citizens and resident aliens as shareholders.

The shareholders must generally be individuals (and certain limited types of trusts), and the corporation must generally have a calendar year. If there are multiple classes of stock, only differences in voting rights are allowed. For most small businesses, these criteria are easy to meet.

If the owners are more comfortable with the corporate form than an LLC, an S corporation can be a good choice. However, the accounting rules for S corporations are more complicated.

Moreover, converting from C to S can be somewhat involved. An S corporation can face corporate tax if it was previously a C corporation and elected S status within the last 5 years (the built-in gain tax).

How do you weigh the pluses and minuses of S vs. C on your facts?

Run some numbers both ways, and get some professional advice. If you incur losses, you want to claim them personally if you can, so consider that possibility too.

Consider operating income vs. sale proceeds, and consider the potentially huge QUALIFIED SMALL BUSINESS STOCK benefit v. the risk of double tax that usually follows from C corporation status. Guessing right isn't just about luck.

See the related Article at web-link as follows: **http://www.foxboro-consulting.com/wp-content/uploads/2019/01/IRS-Section-1202-Small-Business-Stock-Capital-Gains-Exclusion-12-31-2018.pdf**

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