S CORP vs. C CORP vs. LLC: WHICH IS RIGHT FOR YOUR BUSINESS?

One of the significant decisions you face when starting a company is deciding through which type of legal entity you will operate the business. And for existing businesses, an evaluation should be made annually as to whether the type of entity you are using is still the best choice for you. This article discusses the advantages and disadvantages of the three entity types generally used by technology companies: (1) Sub S Corporation; (2) C Corporation; and (3) limited liability company (LLC).

What are Your Choices?
If the business will have only one owner, then you could operate it as an unincorporated sole proprietorship. In other words, you would own the business directly without any legal entity in place.
However, because this format would offer you no legal liability protection, it will rarely be used unless the business is a one-person consulting operation; and even then the use of a legal entity may be very beneficial from a perception standpoint. For a one-owner business, the choices of entity are basically limited to a subchapter S corporation, a subchapter C corporation, or a single-member LLC (treated as a "disregarded entity" for income tax purposes).

For a business with more than one owner, you can add to the list of choices a partnership. The general partnership format, like a sole proprietorship, offers no legal liability protection, so it will rarely be a good choice. However, it is discussed in this article merely because the tax rules that apply to LLCs are based on the tax rules that apply to partnerships.

What are Subchapter C and Subchapter S?
An incorporated entity is automatically a "Subchapter C" corporation unless it elects "Subchapter S" status. A "C" corporation is a separate taxable entity, subject to Federal and state income tax on its net profits. Any profits distributed to shareholders as dividends are subjected to a second level of tax at the shareholder level.

If a corporation elects Subchapter S status, then the entity is largely ignored from an income tax perspective, and the shareholders are taxed directly on the profits of the corporation. The profits are not subject to a second level of tax when distributed as dividends.

The S election has no effect on the corporation other than for income tax purposes. It does not in any way impact the legal liability protection that the corporate form provides.
Advantages of Subchapter S Election

The primary advantage of the S election is the ability to avoid the corporate level tax (i.e. double taxation). Prior to the Tax Reform Act of 1986, it was possible to let earnings accumulate inside a C corporation and bail the earnings out at a later date without a second level of tax by way of a liquidation of the entity. The Tax Reform Act of 1986, however, eliminated this loophole. Thus, the S election has been very popular since 1987, as a way to permanently avoid a second level of tax.

The second level of tax is avoided either by virtue of distributions being tax free to the shareholders or upon sale of the company stock by virtue of the step up in basis of the S corporation stock for earnings retained in the corporation; neither of which is permitted for C corporations.

Owner-operated companies are frequently able to avoid the second level of tax by bailing all of the earnings out through payment of compensation to the employee/shareholder rather than payment of dividends. However, the IRS may seek to characterize a portion of the compensation as a constructive dividend. This has devastating consequences as the payment would still be taxable to the shareholder, but would be nondeductible for the C Corporation.

Even if you are successful in bailing out the earnings of the corporation from operations each year through payment of compensation, the C corporation form may come back to haunt you upon a sale of the business. Buyers of a corporate enterprise generally wish to purchase assets rather than stock. There are two general reasons for this preference for assets over stock: (1) to avoid assumption of unknown liabilities of the selling corporation; and (2) to achieve a step-up in the tax basis of the assets. Even if your company does not have much in the way of tangible assets, it likely will have very valuable intangible assets such as customer list, favorable contracts in place, skilled work force in place, recognized name, technology, etc. Current tax law, enacted in 1993, makes all of these intangibles amortizable for income tax purposes, and thus a buyer of the business will want to be able to write the tax basis of the assets up to fair market value.

If a C corporation sells assets, it is taxed once upon the gain at the corporate level, and then the proceeds are taxed again upon distribution to the shareholders. "Built-in gain" rules prevent the corporation from making an S election just prior to selling in order to avoid the corporate tax.

In this scenario you might be able to insist upon a stock sale rather than an asset sale, but this may result in a reduction of the sales price.
**Disadvantages of S Election**

If there were no disadvantages to the S election, then obviously all qualifying corporations would make the election. Unfortunately, there are some disadvantages.

The primary disadvantages of the S election are: (1) limitations on ownership structure; (2) loss of lower corporate marginal rates on taxable income of less than $75,000; (3) restriction on allowable tax year; and (4) limitation on health insurance deduction for owners.

The ownership restrictions basically require that all shareholders be individuals (US citizens or resident aliens) and that there not be more than 75 shareholders. S corporation stock cannot be owned by a corporation, partnership or other entity, other than certain qualified trusts and tax-exempt entities. The S corporation can only have one class of stock; and an S corporation cannot own more than 79% of the stock of another corporation, unless the entity is a Qualified Subchapter S Subsidiary. An S corporation can, however, be a partner in a partnership or a member of a limited liability company (LLC).

The restrictions on type of shareholder and classes of stock generally prevent technology companies which are financed by venture capital firms from qualifying for Subchapter S treatment.

S corporations generally must have a calendar year.

C corporations (unless classified as a "personal service corporation") are generally subject to Federal tax at the following rates

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - 50,000</td>
<td>15%</td>
</tr>
<tr>
<td>50,001 - 75,000</td>
<td>25%</td>
</tr>
<tr>
<td>75,001 - 100,000</td>
<td>34%</td>
</tr>
<tr>
<td>100,001 - 335,000</td>
<td>39%</td>
</tr>
</tbody>
</table>

As you can see, the rates on income below $75,000 are well below the rates that individuals are frequently subject to at the personal level. Thus, some income can be retained in a C corporation at a rate that is likely lower than would be paid at the personal level if the corporation were an S corporation, thus resulting in a current tax savings.

One additional disadvantage that would likely have a current tax cost to you is that shareholders of S corporations cannot exclude from their taxable income the health insurance premiums paid on their behalf by the corporation. Instead they may take a deduction on their personal return, but only for 60% of the amount.
C Corporation 50% Capital Gains Exclusion and Section 1045 Rollover Provision
The 1993 Tax Act included a beneficial provision for C corporations that puts an additional wrinkle into the C vs. S analysis. The provision permits a 50% capital gains exclusion for sales of stock in certain C corporations. To be eligible, the stock must have been issued after the August 1993 enactment date and must be held at least five years. The corporation must be a C-corp. and must meet various other limitations on size and nature of business activities. Unfortunately, much of the benefit of this provision is frequently recaptured via the "alternative minimum tax".

The 1997 Tax Act added a related provision, "Section 1045", which permits the "rollover" of gain from the sale of stock of a qualified small C-corp. if the stock has been held for more than six months and the proceeds are reinvested in another qualifying small C-corp. within 60 days.

Consideration of Non-Corporate Entities
The above S vs. C analysis assumes that you will utilize a corporation. However, you might instead conduct your business through either a partnership or a limited liability company (LLC).

Partnership
A partnership, much like an S corporation, is a transparent entity which is not subject to income tax. The income of a partnership is taxed on the personal returns of the partners, regardless of whether the income is distributed or retained within the entity. The partnership vehicle is much more flexible than an S corporation, in that there are (for the most part) no restrictions on ownership, and profits and losses may be allocated any way you choose, provided such allocations have substantial economic effect.

Distributions of cash from a partnership are never taxable to a partner unless they exceed the partner's tax basis in the partnership, which includes the partner's original investment in the partnership, any undistributed earnings of the partnership, and the partner's share of liabilities of the partnership. Noncash distributions are generally nontaxable, even if in excess of the partner's basis. In this manner, the partnership form is more advantageous than the S corporation, in that distributions from an S corporation in excess of a shareholder's basis (which generally does not include the liabilities of the corporation) are taxable, and distributions of noncash assets by an S corporation can trigger taxable gain.

Partnerships fall into three categories: (1) general partnerships, (2) limited partnerships, and limited liability partnerships. Partners in a general partnership can be held legally liable for any debts of the partnership. Limited partners in a limited partnership are not held liable for the debts of the partnership, but you must have a general partner in a limited partnership, which normally necessitates the formation of a corporate entity to serve this purpose. A limited liability partnership is a general partnership which has made an election to avail itself of some liability shield. This format is generally used by professional service firms such as accounting and law firms.
The principal advantages of the partnership form are: (1) ease of formation; (2) pass-thru treatment for tax purposes; and (3) flexibility of ownership and allocations. The primary disadvantage is the lack of liability protection (unless a limited partnership or limited liability partnership vehicle is used). Also, partnerships cannot engage in a tax-free merger transaction with a corporation and cannot issue "incentive stock options (ISOs)".

**Limited Liability Company (LLC)**
The LLC is a hybrid entity which combines the tax advantages of a partnership with the legal liability protection of a corporation. Effective March 1, 1994, Georgia enacted legislation permitting the formation of LLCs.

Many consider the LLC to be the best of all worlds, and it has become the entity of choice over the past few years. The LLC will not be the appropriate choice in all cases, however. For example:

1) Self-employment tax may apply to each active individual member's share of the profits; whereas with S-corp. amounts that are reasonably classified as distributions (as opposed to salary) escape FICA tax.

2) An LLC cannot engage in a tax-free merger with a corporation. It may possible to achieve a tax-free incorporation prior to entering into a merger transaction, but this carries with it some risks and limitations.

3) An LLC cannot issue "incentive stock options". It may be possible, however, to achieve a similar result by carefully structuring the allocation provisions of your LLC operating agreement.

4) The hassle factor of having to issue K-1s to each owner.

5) VCs generally prefer C-corps.

6) Public companies generally must be C-corps, so conversion from LLC status to C-corp. status would be necessary in order to do an IPO.
Conversion From One Type of Entity to Another
It is generally possible to convert from one type of entity to another, and frequently this can be accomplished tax free. However, because of the inherent risk that a taxable gain will unintentionally be triggered in the process, the specifics of your situation must be carefully analyzed before undertaking a conversion.

Summary
The choice as to the appropriate entity through which to operate your technology business is an important one, both from a tax and legal perspective, that can effect you for years to come. It should be addressed before starting the business and on an annual basis thereafter.

This article is presented for educational and informational purposes only, and is not intended to constitute legal, tax or accounting advice. The article provides only a very general summary of complex rules. For advice on how these rules may apply to your specific situation, contact a professional tax advisor.