

Tax Considerations in Choosing the Form of Organization for a New Business

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Founders of a new business typically realize early on that they need to conduct the business through a legal entity to limit their personal liabilities for the debts and obligations the business generates. Often, the three entity types from which the founders must choose are the “C” corporation, the “S” corporation and the limited liability company (or “LLC”). While all three entity types insulate the founders from personal liability, the differences among the three types for tax purposes may be substantial. A C corporation, on the one hand, reports and pays tax on its income separately from its owners. The income or loss of an S corporation or LLC, on the other hand, generally is reported by the owners on their personal returns.¹ The choice, therefore, is often tax-driven and requires an analysis of how the founders expect to grow and profit from the business.²

The C Corporation

Some Basics. A C corporation reports and pays tax on its income at a rate that was reduced by the Tax Cuts and Jobs Act of 2017 (the “TCJA”) to 21% from a maximum of 35%.³ Any distribution made by a C corporation to its stockholders with respect to their shares is generally treated as a dividend to the extent the distribution is made from the corporation’s current or accumulated “earnings and profits” (or as sale proceeds if made in exchange for the stockholders’ shares, such as in connection with the liquidation of the corporation). A U.S. individual’s dividends from a domestic (or qualified foreign) corporation are generally taxable at a maximum rate of 15% or, for an individual with taxable income exceeding \$425,800 (\$479,000 if married filing jointly), 20% (plus, if applicable, an additional 3.8% tax on net investment income).⁴ Thus, the earnings of a C corporation are subject to tax at the corporate level when earned and then again at the stockholder level when distributed, net of corporate-level tax, as dividends (or liquidation proceeds).⁵ Although the “double-taxation” of the distributed earnings of a C corporation (including gain from an asset sale) has historically been cited as a disadvantage of C corporations as compared to S corporations and LLCs, the differences between the effective rates applicable to the distributed earnings of a C corporation, on the one hand, and the distributed earnings of an S corporation or LLC, on the other, have been significantly reduced by the TCJA.⁶ The losses of a C corporation are also reported by the corporation rather than by its stockholders.⁷ With limited exceptions, the stockholders report any losses they have with respect to their shares as capital losses only when they dispose of their shares. Individuals may use capital losses to offset only capital gains and small amounts of ordinary income (and may carry unused capital losses forward but not back).

Factors Favoring the C Corporation. While the potential for double-taxation can be a serious concern, a number of factors may favor the C corporation. Those factors include the following:

- With the corporate tax rate now so much lower (by way of the TCJA) than the maximum individual rate applicable to ordinary income, the use of a C corporation rather than an S corporation or LLC allows for a significantly lower effective tax rate on retained earnings.

- The stockholders of a C corporation are generally subject to tax only on dividends they receive with respect to, and gains they have on sales of, their shares.⁸ They are generally not required by reason of their stock holdings to file returns in the states where the corporation has to file.
- Only shares of stock issued by C corporations may be “qualified small business stock” (or “QSBS”). If certain requirements are satisfied, and subject to certain limitations, an individual may (i) exclude a portion of his or her gain on the sale of QSBS held for more than five years or (ii) roll his or her gain on a sale of QSBS held for more than six months into another qualified small business.⁹
- Venture capital funds generally prefer to invest in C corporations. S corporations are not suitable candidates for investment by venture capital funds because S corporations may not have partnerships among their stockholders and may not issue preferred stock. Equity investments of venture capital funds in LLCs can cause tax problems for the funds’ tax-exempt and foreign partners.
- Equity-based compensation arrangements are simplest and most “traditional” with C corporations. C corporations (and S corporations, but not LLCs) may grant “incentive stock options” (or “ISOs”).
- Subject to certain limitations, a C corporation may carry its net operating losses forward indefinitely for use against income it has in those other years.¹⁰

When a C Corporation Makes Sense. Founders should consider a C corporation if they anticipate that their profit is more likely to derive from a sale of the business than from periodic distributions of the earnings of the business, particularly if they (i) intend to grow their business using retained earnings and/or venture capital financing, (ii) anticipate that they will hold their shares of stock for more than five years and (iii) anticipate making equity awards to employees and other service providers.

The S Corporation

Some Basics. The income of an S corporation is generally not taxed to the corporation.¹¹ Instead, the income is reported by the corporation’s stockholders in proportion to their stockholdings and without regard to the amounts of their distributions.¹² Distributions to the stockholders of “tax-paid” income are not taxed again to the stockholders.¹³ The losses of an S corporation are also reported by the stockholders in proportion to their stockholdings.¹⁴ Thus, the use of an S corporation generally avoids the double-taxation of distributed earnings characteristic of a C corporation and allows the stockholders to report their shares of the corporation’s loss (subject to any applicable deductibility limitations). Unfortunately, the requirements for qualifying as an S corporation significantly limit an S corporation’s utility. For example, an S corporation must be owned entirely by U.S. resident individuals, estates, certain types of trusts and certain tax-exempt organizations (that is, none of the stockholders may be corporations, partnerships or non-U.S. persons).¹⁵ In addition, an S corporation may have only a single class of stock outstanding (differences in voting rights are permissible, but differences in rights to distributions generally are not).

Factors Favoring the S Corporation. Often, founders must first decide between a C corporation, on the one hand, and an S corporation or LLC, on the other (that is, between a taxable entity and a non-taxable, or “pass-through,” entity). Then, if the founders have ruled out a C corporation, they must decide between an S corporation and an LLC. Among the factors that may favor an S corporation over an LLC are the following:

- An S corporation may be more versatile than an LLC in terms of exit strategy. An S corporation (like a C corporation but not an LLC) may be acquired in a transaction qualifying as a “reorganization” that enables its stockholders to exchange their stock for stock of the acquiring corporation (or an affiliate) without incurring current tax liability (other than on any cash or other non-stock property they receive). In addition, the owners of an S corporation

(but not the owners of an LLC) may avoid reporting any of their exit gain as ordinary income by structuring their exit as a stock sale (as opposed to an asset sale).¹⁶

- Although equity incentive arrangements are more complicated with S corporations than with C corporations, they are simpler with S corporations than with LLCs. Like C corporations, S corporations may grant ISOs.
- If an owner-employee of an S corporation receives reasonable wage payments from the S corporation, only the wage payments (but not his or her share of the income of the S corporation as a stockholder) are subject to employment tax. An owner-employee of an LLC, on the other hand, may be subject to self-employment tax on his or her entire share of the LLC's business income.¹⁷
- S corporations may be eligible for local property tax exemptions that are not available to LLCs. These exemptions can be particularly important if the business will have significant amounts of inventory, machinery or other personal property.

When an S Corporation Makes Sense. Founders should consider an S corporation if they can satisfy the S corporation qualification requirements and want a simple arrangement that will avoid the double-taxation of distributed earnings and allow them to report their shares of any losses while (i) preserving their ability to exchange their stock for stock of an acquiror on a non-taxable basis in a "reorganization," (ii) maintaining their ability to motivate employees and consultants with more traditional corporate equity incentives, and (iii) minimizing employment taxes (and employment tax complexities).

The LLC

Some Basics. The income of an LLC is reported by the LLC's owners in accordance with their agreement (which need not provide for pro rata allocations) and without regard to the amounts of their distributions.¹⁸ Distributions to the owners of "tax-paid" income are not taxed again to the owners.¹⁹ The losses of an LLC are also reported by the owners in accordance with their agreement.²⁰ Because of its "pass-through" nature, an LLC (like an S corporation) avoids the double-taxation of distributed earnings characteristic of the C corporation while allowing the owners to report their shares of the LLC's losses (subject to any applicable deductibility limitations). The partnership tax rules can provide an LLC with certain advantages over an S corporation, but those tax rules can be complicated.

Factors Favoring the LLC. Among the factors that may favor the LLC are the following:

- Because an LLC is a partnership for tax purposes (and need not satisfy the S corporation qualification requirements), it may have multiple classes of owners (with different economic rights and preferences, subject to the requirement that allocations of its income and loss have "substantial economic effect") and may include entities and foreigners among its owners.
- With certain exceptions, an LLC may distribute appreciated assets without triggering gain. Assets may therefore pass out of an LLC more freely than with an S corporation (or a C corporation).²¹
- To avoid tax on a contribution of appreciated property to an S corporation (or C corporation) for stock, the person making the contribution must, among other things, own (either individually or together with other persons making contemporaneous contributions of cash or property to the corporation for stock) at least 80% of the total combined voting power of all classes of stock entitled to vote (and of the total number of shares of all other classes of stock) outstanding as of the time immediately after the contribution is made. No such "control" requirement applies to contributions of appreciated property to LLCs. As a result, adding new owners for property contributions can be simpler for LLCs than for S corporations.
- The owners of an LLC may include their shares of the LLC's borrowings in their tax bases in

their interests in the LLC, even if they are not personally liable for the borrowings.²² The inclusion of borrowings in basis can allow owners of interests in LLCs to use greater amounts of loss (subject to certain “at risk,” “passive activity loss” and “excess business loss” rules), and receive greater amounts of non-taxable distributions, than can stockholders of S corporations.

- If an LLC makes a special tax election, a transferee of an interest in the LLC by purchase or inheritance may “write up” his or her share of the LLC’s basis in its assets to his or her initial basis in his or her interest in the LLC (thereby enabling him or her to report less income or greater deductions with respect to the assets). In contrast, the purchase or inheritance of stock in an S corporation (or C corporation) generally has no effect on the corporation’s basis in its assets.²³
- Depending on the circumstances, the buy-out by the LLC of an interest of an owner can result in asset basis increases or even deductible payments for the benefit of the LLC and its remaining owners. In contrast, buy-out payments by a corporation generally provide no basis increases or deductions.
- LLCs can provide equity incentives in the form of “profits interests” entitling their recipients to participate only in appreciation in the value of the LLC after the particular awards are made. Depending on the circumstances, profits interests can facilitate participation of recipients in exit gains at capital gain rates without requiring that the recipients pay tax or purchase price for the interests upon receiving the interests.²⁴
- Sometimes, the founders of a business believe they will ultimately need a C corporation but want a “pass-through” entity initially to avoid double-taxation on an asset sale and/or report their shares of the losses of the business before the business has received venture capital financing. The “wait and see” approach may be better served by using an LLC as the initial entity because, among other things, stock received by the founders when they convert their LLC to a C corporation can be QSBS.

When an LLC Makes Sense. Founders should consider the LLC if they want a “pass-through” entity that (i) is unable to satisfy the S corporation qualification requirements (because, for example, it will have entities as owners or multiple classes of equity interests), (ii) may distribute appreciated assets (such as securities or real estate), (iii) may have borrowings that will generate tax losses or distributions, and/or (iv) may buy out owners from time to time. The LLC may also be the best choice when the founders want to use a pass-through entity on an interim basis without precluding the ultimate treatment of their interests in the business as QSBS.

Conclusion

In conclusion, the founders of a business should consider using a C corporation if they intend to derive their profit by selling the business after growing it using retained earnings or venture capital financing. If the founders expect the business to generate significant amounts of earnings that will be distributed from time to time, however, they should consider using an S corporation or an LLC (particularly if the earnings will be “qualified business income” eligible for the new 20% deduction introduced by the TCJA). As between the S corporation and the LLC, the choice (at least from a federal income tax standpoint) may depend on whether the S corporation qualification requirements can be satisfied and whether any of the additional capabilities of an LLC outweigh the relative advantages of an S corporation.

If you would like to discuss choice of entity issues, please contact [Chip Wry](#), [Dave Czarnecki](#), or [Joe Hunt](#).

For more information on how the TCJA of 2017 affects choice of entity, see [C Corporations and Pass-Through Entities Under the New Tax Regime](#).

Footnotes.

1. For tax purposes, an LLC is a partnership if it has two or more owners or is disregarded as an entity (and treated as a sole proprietorship) if it has only one owner unless, in either case, it has elected to be classified as a corporation. Unless otherwise noted, LLCs are presumed in this article to be partnerships for tax purposes.
2. This article is not intended to be an exhaustive analysis of the tax differences among C corporations, S corporations and LLCs. In addition, the tax results described in this article are based only on the U.S. federal income tax rules. State, local and foreign tax consequences are not discussed in this article except as otherwise noted.
3. There are no preferential rates applicable to long-term capital gains of C corporations. Before the rate reduction made by the TCJA, a C corporation was taxed at rates of (i) 15% on its first \$50,000 of taxable income, (ii) 25% on its taxable income from \$50,001 to \$75,000, (iii) 34% on its taxable income from \$75,001 to \$10,000,000 and (iv) 35% on its taxable income in excess of \$10,000,000. In addition, prior to the TCJA, "qualified personal service corporations" were subject to a flat 35% tax on their taxable incomes.
4. Currently, an individual with "modified adjusted gross income" exceeding a threshold (\$200,000 or, if the individual is married filing jointly, \$250,000) is subject to a 3.8% tax on the lesser of (i) his or her "net investment income" or (ii) the amount of his or her modified adjusted gross income in excess of the threshold. "Net investment income" includes, net of "properly allocable deductions," (a) interest, dividends, annuities, royalties and rents (with an exception for such income derived from non-passive activities), (b) income from passive activities, and (c) gains from dispositions of property (with exceptions for gains from dispositions of property held, and of interests, in non-passive activities). For high income individuals, therefore, dividends are subject to a maximum 23.8% tax. The tax on net investment income also applies to estates and trusts.
5. The effective rate applicable to the distributed earnings of a C corporation can be as high as 36.8% (or 39.8% if the distribution is subject to the 3.8% tax on net investment income in the hands of the stockholders). Earnings paid out to stockholders are not subject to double-tax to the extent they can be paid out as principal repayments on loans by the stockholders (care must be taken in structuring stockholder loans to ensure their treatment as debt rather than equity) or in some deductible way, such as compensation for services (compensation, though, must be reasonable to be deductible and is subject to employment tax). It should also be noted that C corporations may deduct portions of the dividends they receive from other domestic corporations.
6. For a discussion of the effective rates applicable to an individual's share of the income of an S corporation or LLC, see footnote 12.
7. Subject to certain limitations (including one that applies to an S corporation with respect to which there has occurred an "ownership change"), a C corporation with a "net operating loss" for any year may carry the loss forward indefinitely for use against income it has in those other years. Before the TCJA, a C corporation could carry a net operating loss back 2 years and forward 20 years.
8. Stockholders of a C corporation (unlike stockholders of an S corporation and owners of an LLC) do not, however, include the corporation's retained earnings in their adjusted tax bases in their shares for purposes of determining their gains and losses on sales of their shares.

9. For QSBS acquired after September 27, 2010 and held for more than five years, the percentage of the gain that may be excluded is 100%. The aggregate amount that may be excluded by any taxpayer on sales of the stock of any issuer is in any event subject to a cap, however, equal to the greater of (i) \$10 million (\$5 million for a married individual filing a separate return) or (ii) ten times the taxpayer's adjusted tax basis in the stock.

10. Losses of S corporations or LLCs may be carried forward as well, but the losses remain with the owners to whom they were allocated. Thus, if an S corporation or LLC with prior losses converts to a C corporation, the prior losses are not available to offset income of the C corporation.

11. Notwithstanding the general rule, an S corporation can be subject to corporate-level tax under certain circumstances if it has been a C corporation or it holds assets acquired from a C corporation in a tax-free transaction. In addition, states may impose corporate-level taxes on S corporations (as does Massachusetts in the case of S corporations with gross receipts exceeding certain levels).

12. The stockholders report their shares of the corporation's income at their rates, with the income generally having the character in their hands that it would have had if they had earned the income directly. After the TCJA, the maximum rate applicable to an individual's income (including an individual's share of the income of an S corporation) is 37% (down from 39.6%, and with the top rate applying to an individual with taxable income exceeding \$500,000, or \$600,000 if married filing jointly), although (i) an individual's long-term capital gain (including an individual's share of a long-term capital gain of an S corporation) remains subject to tax at a maximum rate of 15% or, if the individual has taxable income exceeding \$425,800 (\$479,000 if married filing jointly), 20%, and (ii) the 3.8% tax on net investment income can apply to the share of the income or gain of an S corporation allocated to an individual for whom the S corporation is a passive activity (as noted above, and for comparison's sake, the 3.8% tax can also apply to dividends received by an individual from a C corporation). In addition, the TCJA added a new provision permitting an individual (or other non-corporate) taxpayer to deduct, for any year with respect to any "qualified trade or business" conducted by an S corporation (or LLC or sole proprietorship) in which he or she holds an interest, up to the lesser of (i) 20% of his or her "qualified business income" from the qualified trade or business for the year or (ii) the greater of (a) his or her share of 50% of the "W-2 wages" paid by the qualified trade or business for the year or (b) his or her share of 25% of the W-2 wages paid by the qualified trade or business for the year plus his or her share of 2.5% of the unadjusted basis of certain "qualified property" of the qualified trade or business (basically, depreciable tangible property used in the production of "qualified business income" and as to which a "depreciable period" has not expired). "Qualified business income" is, basically, net income from a U.S. qualified trade or business (with exceptions for, among other things, capital gains and losses (both short- and long-term), dividends, interest income not allocable to a trade or business, reasonable compensation for services and "guaranteed payments" to partners for services rendered to their partnerships, and deductions and losses allocable to excluded income). A "qualified trade or business" is any trade or business other than a "specified service trade or business" (with an exception for taxpayers with taxable incomes below a "threshold amount") or the trade or business of performing services as an employee. A "specified service trade or business" is any trade or business involving the performance of services (i) in the field of health, law, accounting, actuarial services, performing arts, consulting, athletics, financial services or where the principal asset of the business is the reputation or skill of one or more of its employees (but with a specific exception for architectural and engineering services), or (ii) that consist of investing and investment management, trading, or dealing in securities, partnership interests or commodities. The effect of the 20% deduction can be to reduce the maximum rate applicable to a non-corporate taxpayer's share of the ordinary income of an S corporation (or LLC or sole proprietorship) to as low as 29.6%.

13. In general (if the corporation has no retained earnings from any period during which it was a

C corporation), a distribution by an S corporation to a stockholder is taxable to the stockholder only to the extent it exceeds the stockholder's adjusted tax basis in his or her shares of stock in the corporation. At any given time, an S corporation stockholder's adjusted tax basis in his or her shares is generally equal to (i) his or her capital contributions to the corporation, plus (ii) the income that has been allocated to him or her, minus (but not below zero) (iii) (a) the losses that have been allocated to him or her and (b) the distributions he or she has received.

14. The amount of loss that a stockholder may deduct may not exceed his or her adjusted tax basis in his or her shares of stock in the corporation (and in any loans he or she has made to the corporation). In addition, the deductibility of a stockholder's share of a loss may be limited by, among other things, (i) certain "at risk" and "passive activity loss" rules, (ii) if the loss is a capital loss, the amount of the stockholder's capital gains (plus a small amount of ordinary income) and (iii) a new provision added by the TCJA that prevents non-corporate taxpayers from deducting (and instead requiring that they carry forward) their "excess business losses." An S corporation stockholder's "excess business loss" for any year is the excess of (i) his or her aggregate deductions for the year from trades or businesses over (ii) the sum of (a) his or her aggregate gross income or gain attributable to such trades or businesses plus (b) \$250,000 (\$500,000 in the case of a taxpayer filing a joint return). In the case of an S corporation (or LLC), the limitation is applied at the owner level.

15. Under the TCJA, non-U.S. persons can now be beneficiaries of certain types of trusts, called "electing small business trusts," that can hold shares of S corporations.

16. If at least 80% of the corporation's stock is sold, the stockholders may agree with the acquiror(s) to treat the sale as an asset sale for tax purposes. In that case, some portion of their exit gain may be ordinary income. Such an agreement may result from negotiations with the acquiror(s).

17. Compensation payments to owners of interests in LLCs are also generally not subject to withholding. The owners of interests in LLCs must therefore make their own periodic income and self-employment tax filings.

18. The owners report their shares of the LLC's income at their rates, with the income generally having the character in their hands that it would have had if they had earned the income directly. To be respected by the Internal Revenue Service, an LLC's allocations of income and loss must be consistent with the LLC's economics (the allocations must have "substantial economic effect"). Thus, allocations of income and loss are supposed to have corresponding effects on the amounts of distributions the owners ultimately receive. Like the income of an S corporation in the hands of an individual stockholder, the maximum rate applicable to an individual's share of the income of an LLC is 37% (down from 39.6%, and with the top rate applying to an individual with taxable income exceeding \$500,000, or \$600,000 if married filing jointly), although (i) an individual's long-term capital gain (including an individual's share of a long-term capital gain of an LLC, subject to the addition by the TCJA of a new three-year holding period requirement for gains with respect to certain interests in private investment partnerships) generally remains subject to tax at a maximum rate of 15% or, if the individual has taxable income exceeding \$425,800 (\$479,000 if married filing jointly), 20%, (ii) the 3.8% tax on net investment income can apply to the share of the income or gain of an LLC allocated to an individual for whom the LLC is a passive activity (as noted above, and for comparison's sake, the 3.8% tax can also apply to dividends received by an individual from a C corporation), and (iii) an individual (or other non-corporate) owner of an interest in an LLC may deduct for any year up to the lesser of (a) 20% of his or her qualified business income for the year from any qualified trade or business conducted by the LLC or (b) the greater of (1) his or her share of 50% of the W-2 wages paid by the qualified trade or business for the year or (2) his or her share of 25% of the W-2 wages paid by the qualified trade or business for the year plus his or her share of 2.5% of the unadjusted basis of all qualified property of the qualified trade or business (see footnote 12).

19. In general, a distribution by an LLC to an owner is taxable to the owner only to the extent it exceeds the owner's adjusted tax basis in his or her interest in the LLC. At any given time, an owner's adjusted tax basis in his or her interest in the LLC is generally equal to (i) his or her capital contributions to the LLC, plus (ii) the income that has been allocated to him or her, minus (but not below zero) (iii) (a) the losses that have been allocated to him or her and (b) the distributions he or she has received. Any increase (or decrease) in an owner's share of the LLC's debt is treated, for purposes of measuring his or her adjusted tax basis in his or her interest in the LLC, as a contribution by (or distribution to) him or her.

20. Deductibility limitations similar to those applicable to losses of individual stockholders of S corporations (including the limitation added by the TCJA on the deductibility of "excess business losses") apply to losses of individual owners of interests in LLCs (see footnote 14), except that the owners of an LLC include their shares of the debt of the LLC in their bases in their interests in the LLC.

21. The conversion of an LLC to a corporation, or of a corporation to an LLC, generally involves a distribution of assets by the converting entity for tax purposes. Because an LLC (but not a corporation) can generally distribute appreciated assets without triggering gain, the LLC is far more easily converted (than the corporation, at least for tax purposes) to the other. Thus, where the choice of entity is uncertain, it may be best to form the entity as an LLC.

22. The rules for determining the owners' shares of an LLC's debt are complicated. Basically, however, any increase (or decrease) in an owner's share of the LLC's debt is treated, for purposes of measuring his or her adjusted tax basis in his or her interest in the LLC, as a contribution by (or distribution to) him or her.

23. As noted in footnote 16, if at least 80% of the corporation's stock is sold, the stockholders may agree with the acquiror(s) to treat the sale as an asset sale for tax purposes.

24. C corporations and S corporations can grant ISOs and make restricted stock awards, but those types of awards often do not result in the participation of the recipients in exit gains at capital gain rates without the recipients having to pay tax and/or purchase price upon receiving their shares.