CHOICE OF ENTITY

DESPITE HIGHER TAX RATES, S CORPORATIONS RETAIN ADVANTAGES OVER C CORPORATIONS

While individual rates have gone up, the full tax picture often shows that operating as an S corporation remains the wiser choice.

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[pg. 271]

After recent tax changes, owners of small businesses face a question: Should the business continue to function as an S corporation, or should the entity revoke its election under Subchapter S of the Code? **1**

Despite a number of statutory constraints, conventional wisdom has generally favored an S corporation classification. An S corporation is a pass-through entity whose shareholders **2** are subject to personal income tax based on the income of the corporation. **3** A C corporation, by contrast, is taxed as a separate entity at corporate rates, **4** and its distributions to shareholders are subject to the personal income tax. **5** A small business corporation electing under Subchapter S may have no more than 100 shareholders, **6** and may not have more than one class of stock. **7** There are no similar constraints on C corporations. Nevertheless, an S corporation classification provides business owners a superior degree of flexibility and is therefore generally preferred. Specifically, by having its income flow directly to its shareholders, an S corporation is not subject to the double taxation that a C corporation may be unable to avoid.

Superficially, the American Taxpayer Relief Act of 2012, **8** which was signed into law by President Barack Obama on 1/2/13 to avoid the "fiscal cliff," appears to contradict the foregoing conventional wisdom. The legislation increases the highest federal tax rate for individuals to 39.6% **9** and provides for an additional 3.8% tax on net investment income. **10** Prior to this legislation, the highest tax rate for both individuals and corporations was 35%. The highest corporate tax rate, however, remains 35%. **11**

Tax rates are not the whole story

Given that the highest federal individual tax rate is now higher than the corporate rate, it may seem like operating a business through a C corporation rather than a flow-through entity would present a preferable alternative for owners of small, growing businesses. They may reevaluate their decision to elect a classification under Subchapter S and consider such restructuring to take advantage of the lower corporate rate available to C corporations, with the intent to reduce the overall tax obligation that would otherwise burden its shareholders.

Such a simplistic analysis, however, is imprudent. A number of tax considerations may still favor an S election, even in light of the generally increased personal income tax rate.

[pg. 272]

Business owners are thus well-advised to avoid brashly reacting to the increased highest individual tax rate by disregarding the benefits of an S corporation classification. They may find that an S election continues to provide significant tax savings to their businesses despite the increased highest individual tax rate.

Medicare tax exclusion for material participation

The Medicare tax on net investment income applies to trade or business income resulting from a passive activity within the meaning of **Section 469** , or the trading in financial instruments or commodities as defined in **Section 475(e)(2)** . **12** As a result, the income received by a taxpayer from a trade or business in which that taxpayer materially participates is not subject to the additional 3.8% tax. This exclusion is not available to shareholders of a C corporation because the passive activity loss rules of **Section 469** do not apply to C corporations unless they are closely held. **13** The exclusion is, however, available to shareholders of S corporations that materially participate in the trade or business of the entity. As a result, S corporation shareholders that are involved in the operations of the entity's trade or business activity on a regular, continuous, and substantial basis are not subject to the additional 3.8% tax on net investment income received as a shareholder of that entity.

Double taxation disadvantage

Other than the carve out from the additional 3.8% tax for material participation by shareholders in S corporations, a major reason to consider staying with S corporation status is to avoid double taxation imposed on income earned by a C corporation and distributed to shareholders. The following example assumes that that the owner materially participates in the company's business.

Example 1: A C corporation, which uses an accrual method of accounting, earns a profit of $1,000,000. The entity itself will have to pay $340,000 in corporate income tax at the federal corporate tax rate of 34%. **14** The entity will then distribute the remaining $660,000 to the owner of the business. At this point, the owner will have to pay the personal income tax on the dividend distribution. The owner will pay 23.8% (for the distribution of retained earnings) of the distribution, or $157,080, in taxes. **15** Accordingly, after compliance with all federal tax requirements associated with this business, the owner is left with $502,920 of a $1,000,000 profit.

In contrast, however, if the same company had made a federal Subchapter S election, the full $1,000,000 profit would flow through to the owner as income. At the highest federal personal income tax rate of 39.6%, the owner would pay $396,000 in income tax. The owner is not subject to the 3.8% tax because he materially participates in the company as defined in **Section 469** and the regulations thereunder. In this scenario, however, there would be no additional tax due on the distribution to the owner. Accordingly, the S corporation owner is left with $604,000 after complying with federal tax laws, while the C corporation owner was able to net a mere $502,920. The owner of the S corporation therefore retains a $101,080 advantage over the owner of the C corporation.

Dounble taxation on sale of corporation

Finally, the risk of double taxation of corporate income arises in any scenario involving the sale of a business. Example 2 continues to assume that the owner materially participates in the business. Because of the regime of double taxation of corporate income, the owner of an S corporation or other flow-through entities will realize significant tax savings when the business is sold.

Example 2: An outsider is interested in purchasing all of the assets of the company. One of those assets is self-created goodwill, with a fair

[pg. 273]

market value (FMV) of $5 million and no tax basis. Assuming the company has been in business for more than one year, the $5 million will flow to the owner of an S corporation as a long-term capital gain, and he or she will then pay 20%, or $1 million of that gain in taxes. **16** Accordingly, the owner will retain $4 million upon the sale of this particular asset.

In the case of a C corporation, however, the $5 million of goodwill will first be reduced by the $1.75 million in corporate taxes that the C corporation will have to remit (assuming that the corporation is at the 35% tax bracket). The remaining $3.25 million will then be distributed to the owner, who must then pay

$774,000 in capital gains taxes on that amount.

Accordingly, the S corporation owner retains $4 million after taxes, while the C corporation owner is left with only $2.5 million. In such a scenario, the owner of an S corporation is ahead by $1.5 million.

Similarly, a stock sale will also provide significant savings to an S corporation shareholder. Assuming the shareholder has held his stock for more than one year, as an S corporation shareholder who materially participates, he will be subject to a 20% tax rate on the gain but not subject to the 3.8% tax on net investment income. A C corporation shareholder will be subject to a 20% tax plus the 3.8% tax regardless of his level of participation

Conclusion

The foregoing examples demonstrate that choice-of-entity decisions are complex and factors beyond the applicable personal or corporate income tax rates should be evaluated before determining whether to switch the organization of a business to a C corporation or to continue as an S corporation. It should be clear from these examples that organizing as a C corporation is not always an advantage. Only by looking at the full tax picture-ideally with the help of an experienced tax professional-and by analyzing likely scenarios, will one be able to determine what entity is most advantageous for your tax bill. It is imperative to take into account the risks of double taxation and other complex contingencies. Paying the higher rate on income flowing from an S corporation can still provide a more beneficial long-term tax situation. Right now, savvy business owners will avoid panic and impulsive decision-making by looking past the specter of the increased individual income tax rates and remembering that, even if corporate rates are lower, flow-through entities may still be the better way to go, all pertinent factors considered.

1

Sections 1361 et. seq.

2

Section 1361(b)(1)(B) limits who may be a shareholder of S corporation stock. A shareholder must be an individual, estate, a trust described in **Section 1361(c)(2)** , or an exempt organization described in **Section 1361(c)(6)** .

3

Sections 1363(b) and **1366** .

4

Section 11 .

5

Section 301 .

6

Section 1361(b)(1)(A) .

7

Section 1361(b)(1)(D) .

8

P.L. 112-240, 1/2/13.

9

Section 1 .

10

Section 1411(a)(1) .

11

Section 11(b)(1)(D)

12

Section 1411(c)(2)

13

Section 469(a)(2) .

14

Section 11(b)(1)(C) .

15

20% is the new highest capital gains tax rate pursuant to **Section 1(h)** , which applies to qualified dividend income pursuant to **Section 1(h)(11)(B)** , plus the 3.8% Medicare tax on net investment income pursuant to **Section 1411** .

16

20% is the new highest capital gains tax rate pursuant to **Section 1(h)** .