C VS. S CORPORATION

WHITE PAPER

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Introduction

"I expect to exit my business down the road, but is there anything I need to do *now*?"

Business owners often ask this question because they suspect that they should be doing something about exiting their businesses right now. These owners are on to something.

Someday, every owner will exit his or her business, either by choice or against his or her will (e.g., death, incapacitation). Far too many owners take a reactive approach to Exit Planning, beginning the process only after something has forced them to consider their exits. Additionally, since busy business owners tend to forego the planning necessary to exit their businesses on their terms, only the most motivated owners spend time or money planning for their departures.

This white paper should motivate you to undertake some kind of planning today, because to delay all Exit Planning may *double the taxes* you will owe upon the sale of your business. Fortunately, the Exit Planning that you must discuss with your advisors and act upon far in advance of your anticipated exit is elementary, simple to execute, and has little impact on the character or conduct of your business.

Minding Your Cs and Ss: The Differences in Corporation Types

Every business is conducted, for income-tax purposes, as either a regular corporation (C corporation) or as some type of flow-through tax entity (e.g., S corporation). Selecting the wrong entity when you start your business can result in the payment of additional taxes during the company's operational years, thereby restricting the capital available for expansion. Having the wrong entity in place as you prepare the business for sale can more than double the tax bill upon that sale.

The best entity for tax purposes during a business' startup and operational years is often a C corporation. However, the C corporation is the worst entity (i.e., it causes the most tax problems) when it comes time to sell the business. Conversely, the best tax entity at the time of a sale—an S corporation—is often a poor choice for tax purposes during the company's operational and growth years.

The specific planning issue that we will discuss is the careful consideration of how you want your business income to be taxed. If you want business income taxed to you directly, your business entity should be an S corporation, limited liability company (LLC), sole proprietorship, or partnership. If you prefer having business income taxed to the business, then you will conduct business as a C corporation.

It is difficult to imagine a more elementary decision, one you made when you founded your business and likely never changed. Usually, little thought is given to minimizing taxes when you first start the business, because there's little income to be taxed. Besides, experienced accountants can adjust taxable income between the company and owner to minimize any current tax on business income. However, consequences—harmful or beneficial—arising from your choice of business entity enter the picture briskly and starkly when you decide to exit your business. Choosing the appropriate

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type of business entity for your business upon your exit can save you time and tax dollars. Operating under the wrong business entity can be the Exit Planning equivalent of watching a speeding truck suddenly swerve headlong into your lane.

For example, if you decided to take advantage of the lower tax rates of a C corporation during your business' startup and growth years, you'll discover that selling its assets results in a tax on all of the gain at the company level. This large amount of income cannot be transferred from the company to you: It stays in the company and is taxed accordingly. This consequence can more than double the taxes that you must eventually pay because you still don't have the proceeds; the company does. Thus, when the proceeds are distributed to you, a second tax is paid. On the other hand, selling the assets of an S corporation usually results in a single tax levied only at the individual level. So, shouldn't every business elect to be treated as an S corporation?

This white paper discusses the answer to that question. It focuses on your company's choice of entity, a choice that should be made as early as possible (preferably at least five years prior to a sale) and that ultimately paves the way around the IRS's oncoming speeding truck, letting you arrive home with as much of your money in your pocket as legally possible.

Let's examine this issue of C vs. S corporations with the help of Gail St. George, a hypothetical business owner.

A Stitch in Time Saves Nine (Hundred Thousand Dollars)

"I need $3 million from the sale of my business, Gailco."

That was the conclusion Gail St. George and her financial advisors reached after careful analysis. Given that Gail's accountant conservatively valued her software-design company at about $4 million, Gail's goal was realistic. She anticipated a 20% capital-gains tax (15% federal and 5% state), netting her over $3 million. She was ready to sell when she first met her deal attorneys.

They reviewed Gailco's financial statement and noted two significant items. First, there weren't many hard assets. As a service company, most of the purchase price would be paid for using "goodwill" (i.e., an asset without any basis). Secondly, they found that Gailco was organized as a C corporation. The attorneys and CPAs told Gail that this entity choice would prove to be a major stumbling block, because any buyer would want to buy Gailco's assets rather than its stock. As a C corporation, Gail could expect her total tax bill to be closer to $2 million.

Gail immediately asked, "How could we have been so wrong?" Wondering whether she was referring to her business attorney, accountant, or herself, Gail's advisors offered an explanation.

"Gail, most potential buyers will want the company's assets. Since Gailco is a C corporation, there is a tax imposed at the corporate level on the sale of those assets. When Gailco receives the $4 million, it is taxed

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on the difference between that $4 million and its basis in the assets being sold. At most, Gailco's basis in its assets is about $1 million, so the tax will be levied on the gain of $3 million. Because the effective tax rate is approximately 40% (35% federal and 5% state), Gailco will pay over $1 million in taxes. When you, in turn, receive the $3 million from Gailco, there will be a second tax—a capital-gains tax—on that gain. That 20% capital-gains tax equals about $500,000, since you, too, have very little basis in your stock. (A situation most owners face.) The net to you is not $3 million. It's a little over $2 million—well short of your goal."

If Gailco were an S corporation, most of the $3 million gain ($4 million sale price minus $1 million basis) would be taxed once at capital-gains rates.

Let's compare the tax results graphically and then examine alternatives and options for sellers of both C and S corporations.

$4 Million Fair Market Value of Business

Sale of Assets			
	Corporate Tax	*Personal Tax*	*Net Proceeds to Owner*
C Corp	$1 million	$750,000	$2.25 million
S Corp	$0	$900,000	$3.1 million

Obviously, Gail failed to choose the entity that would perform best (from a tax standpoint) when she sold her business. Had Gailco been formed as an S corporation, the double tax would have been avoided, because an S corporation is a "flow-through tax entity" with no separate tax at the corporate level. The $4 million sale proceeds would have been taxed as follows: A portion of the sale proceeds equal to their basis would not be taxed at all. A portion would be taxed at ordinary income rates, such as depreciation recapture on the equipment that was sold. The bulk of the sale proceeds would be taxed at capital-gains rates. The average of all of the various rates would be about 25%.

So, what's the difference between a C corporation and an S corporation? Given a $4 million sale price, the difference is another $1 million or so in Gail's pocket instead of the IRS's. However, as mentioned earlier, the entity choice that best suits *doing* business may not be the best entity for *selling* the business. How, then, does a business owner decide which entity to choose?

What Difference Does It Make?

If you were to ask a CPA which business entity he or she suggests, that CPA will typically answer, "A C corporation—at least in the early, capital-formation years of the business." However, ask any investment banker or other transaction advisor which entity they prefer and you will likely hear, "An S corporation, LLC, or perhaps a partnership or sole proprietorship. Anything, *anything*, but a C corporation!"

Whose advice do you follow? More importantly, how do you decide which is the best business entity for you? Let's begin by looking at the income-tax features of both the C corporation and the S corporation.

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Tax Attributes of a C Corporation

A C corporation enjoys income-tax brackets separate from those of its owners. Commonly, the sale of corporate assets is taxed at a 34% rate, based on ordinary tax-rate brackets.

Most businesses, at least in their infancies, need to retain earnings at the business level to fund expansion. For this reason, the C-corporation entity may be best, because it allows owners to pay less in taxes—especially on the first $100,000 of annual retained earnings—than an individual or flow-through entity. Thus, C-corporation status offers significant benefits to a growing business. However, you must beware of simple solutions.

The C corporation's greatest attribute can also be its greatest weakness. Precisely because a C corporation is a separate taxable entity, it pays a tax whenever it sells anything it owns for gain. Imagine a buyer approaching your business with an offer to buy all of its assets for $1 million. Upon receipt of the $1 million, your C corporation will pay a tax on all of the gain. So far, so good. The federal tax will not exceed 35% and will likely be less, depending on the basis in the assets sold.

Next, imagine that you wish to use the cash proceeds for your personal benefit. As soon as you touch the cash from your C corporation, you will trigger a tax avalanche. The IRS will deem this transaction to be a dividend and tax you at 15%. Additionally, you will pay any applicable state tax. Alternatively, you might wish to liquidate the C corporation and use the lower capital-gains rate (also 15% plus any state tax rates). Remember, your C corporation already paid a tax. Now, you pay a second tax on the proceeds from the assets of the business that you in turn receive from the business. The Gailco case is a classic example of these consequences.

Tax Attributes of an S Corporation

Any taxable income retained at the S-corporation level is taxed at the owner's individual income-tax bracket. Once taxed, when that money is paid to an owner in a future year, there is no second tax, because the owner is considered, for income-tax purposes, to own that asset on which a tax has already been paid.

Thus, when a business is sold for $1 million, the total tax consequences affecting the seller's proceeds is a one-time capital-gains tax on the net gain. The owner, then, avoids the second tax that is incurred when a C corporation distributes the net proceeds to its owners and takes advantage of the much lower personal capital-gains rate.

In addition, an S corporation also avoids issues of unreasonable compensation and excess accumulation of earnings, because all earnings are taxed directly to the owner in the year earned. Additionally, Federal Insurance Contributions Act (FICA) expenses can be reduced by attributing some of the money the owner receives each year to Subchapter S dividends as opposed to compensation. Subchapter S dividends are not subject to FICA.

For detailed information regarding the precise capital-gains tax-rate brackets relevant to you, visit http://www.schwab.com/public/schwab/nn/articles/Taxes-Whats-New, or contact us or your tax advisor.

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Non-Tax Issues Related to the C- vs. S-Corporation Choice

Usually, no other factors carry the weight of the tax issue or significantly differentiate C and S corporations. Limited liability is attainable in both C- and S-corporation entities. Voting rights need not differ. An S corporation conducts daily business exactly as a C corporation. The only difference between the C and S corporation is the filing of a one-page IRS form, Form 2553, electing treatment as an S corporation.

However, there are some limitations on the type of shareholders permitted in an S corporation. For example, S-corporation stock may not be owned by another corporation or by a nonresident alien, and some trusts may not be S shareholders.

The Ideal Situation

The taxable-income consequences of an S corporation flow through to the owners of the S corporation, like a partnership. Thus, when an appreciated corporate asset, like goodwill, is sold, the capital gain is taxed directly to the owner of the S corporation.

Often, it makes sense for a business to be a C corporation during its formative years in order to take advantage of the lower income-tax brackets, which in turn lead to faster accumulation of capital within the company. However, when the business is sold, the S-corporation entity is almost always more beneficial, because it can avoid the double-tax consequences of an asset sale.

Seemingly, the best strategy is to operate as a C corporation until just before the company is sold and then quickly convert to an S corporation. This strategy worked well for many years. In fact, it worked so well that the IRS noticed and decided that this strategy was depriving it of tax revenue. So, the IRS changed the rules.

Today, if a regular corporation converts to S status, a 10-year "built-in gains rule" is applied to maximize the tax revenue to the IRS. The built-in gains rule is the IRS's weapon in its attempt to prevent avoidance of the two-tier C-corporation tax.

Every owner of a C corporation who harbors a desire to sell his or her business would do well to understand the basic operation of this rule. Careful attention to its structure will allow you to design and plan to avoid its most onerous features. This rule imposes a corporate-level tax on the built-in gains that exist on assets owned by the former C corporation effective on the conversion date to S status. The built-in gains on those assets are taxed if those specific assets are sold within the five years following the conversion. Any assets carried over from C status may be subject to the built-in gains tax. These assets include furniture, equipment, land, securities, and the goodwill of the business.

Unrecognized income items, such as accounts receivable in a cash-basis corporation and inventory-accounting procedures, create current tax recognition when S status is elected. These income items, if applicable to your company, must be carefully scrutinized by your tax professional for adverse tax consequences. The corporate-level tax is imposed on the unrealized appreciation (i.e., the built-in gain)

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in existence on the conversion date and the built-in gain that is realized when the asset is sold.

It bears repeating that the S corporation incurs built-in gains taxes only upon the **disposition** of an asset. For example, if an asset is sold, there is no built-in gains tax if that asset was acquired after the conversion date or *to the extent the gain is attributable to post-conversion appreciation*.

What Does It All Mean?

If you are considering conversion to S status, **it is critical to use an experienced and competent tax professional**. Proper planning, done upfront and by a professional, can substantially limit the impact of the built-in gains tax. For example, owners can minimize net unrealized built-in gains by having the assets of the company appraised by a competent appraiser.

A sale during the 10-year built-in gains period will not result in a double tax if you can establish that the *appreciation* in the asset occurred *after* the conversion date. Hence, **early conversion, competent tax advice**, and an **appraisal** or valuation that can withstand the scrutiny of the IRS are paramount.

Perhaps the best advice is for C-corporation owners to meet with a tax advisor to discuss the ins and outs of converting to an S corporation.

With that in mind, examine the following sale options for an S corporation and a C corporation.

Sale Options for an S Corporation

If you wish to sell a business organized as an S corporation, you can choose one of three options.

Option 1: Sell assets. You can sell assets and pay a single tax (at the individual level) on the gains from the sale.

Option 2: Sell stock. You can sell stock and pay a capital-gains tax on the difference between the sale price and the basis in your stock. Note that the basis of your stock is likely to be increased by earnings retained in the S corporation during previous years.

For example, a client recently sold his S corporation for $3 million. Over the years, he had retained approximately $1 million in earnings in the corporation. At the time of the sale, the buyer agreed to pay this client $2 million and allowed him to take $1 million in cash and other securities that had been kept at the corporate level. Thus, this client paid a gains tax on the $2 million paid by the buyer and was able to remove $1 million of cash from the business at the time of the sale with no tax liability, since the taxes had been paid in previous years when the income was retained.

Take a moment to contrast that result with a C corporation in which the distribution of the $1 million from the company to the owner would have been taxed again (as would the net proceeds on the $2 million sale of assets). It bears repeating that with an S corporation, an owner has an increased basis due to income retained in the corporation throughout previous years. This upward basis adjustment

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in the owner's stock interest and consequent return of the basis without tax consequence is not allowed with C corporations.

Option 3: Merger. In a merger, the owner exchanges his or her stock for the stock of the acquiring company. Structured properly, this is a tax-free merger, with the owner (i.e., you) receiving stock in the new entity, which can then be sold at a future date. A capital-gains tax will be paid at the future date. The tax is based on the difference between the then-current sale price and your basis in the stock of your company *immediately prior to the merger*.

When an S corporation is involved in a merger, the normal scenario is to have the owner remove cash and other liquid assets—equivalent to his or her basis immediately prior to the sale—from his or her business. This results in a tax-free distribution of cash from the business to the owner. A merger is then based on the value of the S corporation after the cash distribution has been made to the owner.

Note that in all of the possible S-corporation sale scenarios (asset sale, stock sale, or merger), there is only a single tax on the unrealized gain the owner receives as a result of the sale.

Sale Options for a C Corporation

Remember, the double-tax consequences of an asset sale in a C corporation are typically disastrous, often amounting to 40% (or more) of the available sale proceeds. The prudent owner must examine all alternatives before the sale occurs.

Option 1: Sell stock. The sale of stock results in a capital gain to the owner on the difference between the sale price and the owner's basis in the stock (usually very low or nonexistent in most closely held businesses). This is one of the most advisable options, as a single capital-gains tax is imposed on the gain.

Option 2: Sell to a charitable remainder trust (CRT). With proper planning, an owner can *avoid all tax consequences* at the time of sale.

Briefly, the steps are as follows:

1. Create a CRT.
2. Transfer the stock to the CRT.
3. Have the CRT enter into an agreement and sell the stock to a third party.

Option 3: Merge with the buyer's company. Again, there is no tax due at the time of the merger. Eventually, capital-gains taxes will be paid when the owner of the C corporation sells the stock acquired in the merger.

Option 4: Don't sell the business. Hold on to the stock until your death. Continue to receive income for your ongoing efforts connected with the business. Your heirs will receive a stepped-up basis in your stock to the extent of the fair market value of the business on the date of your death. This approach is not recommended for owners who wish to spend their money (however diminished by taxes) before their deaths.

Option 5: Convert to an S corporation. This conversion will be subject to the built-in gains rule previously discussed.

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Although the built-in gains rule is a 10-year rule, much can be achieved by converting to an S corporation a few years before the sale.

Recall how the built-in-gains rule operates. The double tax is not imposed on appreciation of assets after the conversion date. This fact, combined with a **certified** valuation of assets (especially goodwill) that is conservatively low at the time of conversion allows much of the gain on a third-party sale to be taxed only once. Again, the key is allowing as much time as possible to pass between the date of conversion and the date of sale.

Assume Gailco's assets were valued at $2 million (with a $1 million basis) at the date of conversion and the business sold for $4 million four years later. The tax consequences look like this:

$ 4 Million Fair Market Value of Business

	Corporate Tax	***Personal Tax***	***Net Proceeds***
$2 Million C Corp (Built-In Gains)			
	$450,000	$350,000	$1.2 million
$2 Million S Corp (Post-Conversion Appreciation)			
	$0	$450,000	$1,550,000
Total	$450,000	$800,000	$2,750,000

As you can see, much of the adverse tax consequences of a C-corporation sale can often be eliminated if the S-corporation form is elected even a few years before the sale is consummated.

Option 6: Form other flow-through entities now. These flow-through entities (usually in the form of an LLC or partnership) acquire equipment, real property, or other assets (e.g., intellectual property rights, patents, copyrights) that your business uses to operate. When the business and assets are sold, there will be a single tax on the gain recognized by the flow-through entity, and a double tax will be paid to the extent the gain is recognized at the C-corporation level.

For example, assume Gail created an LLC for assets used by Gailco several years before the sale occurred, with the result that the LLC had assets worth $2 million with a basis of $1 million. The results would have looked like this:

$4 Million Fair Market Value of Business

Sale of Assets			
	Corporate Tax	*Personal Tax*	*Net Proceeds*
C Corp	$600,000	$320,000	$1,050,000
LLC	$0	$300,000	$1,700,000
Total			$2,750,000

Option 7: Negotiate to minimize the impact of an asset sale. Several techniques can be used to minimize the double-tax impact of an asset sale. These generally take the form of a direct transfer of dollars from the buyer to you, with a corresponding reduction in the money paid by the buyer to your corporation. The most common techniques are as follows: a covenant not to compete, a consulting agreement, an employment agreement, or a licensing or royalty agreement directly with you. However, in the case of employee-based compensation, the double-tax bite is avoided at the cost of having to continue working and being subject to FICA taxes on some portion of the money you receive. At best, these techniques are a partial offset, not a complete solution, to the double-taxation consequences of selling assets within the C corporation.

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Transferring a Business to Family Members or Key Employees

This paper has highlighted several advantages available to entities other than C corporations when selling a business to an outside third party. Do the same advantages apply when transferring a business to children or key employees?

The answer, very simply, is that the advantages of an S corporation are even greater when you transfer your business to a child or key employee, and those greater advantages are due primarily to the distinguishing factor between a sale to an outside third party and an insider (your business-active child or key employee). That distinguishing factor is money (or more precisely in the case of your insider, the lack of money). An outside third party comes to the closing table with cash. Your child or key employee most likely comes to the closing table with the promise to pay you cash at a future date.

When you sell to an insider, the sole source of your buyout money is the *future income stream of the business*. Given this overarching consideration, it is imperative that the business' future income be transferred to you with the smallest tax loss possible. An asset or stock sale involving a C corporation causes the business' income stream to be reduced by taxation twice: once when the corporation sells its assets (or buys back your stock with nondeductible payments) and once when you sell your stock. Of course, having paid careful attention to the earlier part of this paper, you are already acutely aware of the double tax upon a sale of a C corporation's assets.

You may wonder, "Why do I need to be concerned with two levels of tax when *selling stock* to my child (or employee)?" After all, you will only be taxed on the gain attributable to your stock sale. Remember, the seller in a related party sale must also be concerned with the tax consequences to the buyer, because all of the money is coming from the business.

Remember, the buyer is taxed once when receiving income from the business (as compensation). The buyer then uses part of that compensation to pay you for your stock. The income stream of the business then is taxed twice: once when the buyer receives compensation and again when you receive the net monies from the buyer for the purchase of your stock.

The solution to avoiding the double-tax bite involved in a sale to a related party (whether asset or stock sale) is to value your ownership interest as low as your valuation expert can properly defend and for you to directly receive the future income stream of the business so that it is taxed only once.

As a family-business owner, you begin the transfer process by selling some stock at a low value over time to minimize double-tax consequences to the extent value is attributable to stock ownership. You continue to own a significant amount of S-corporation stock, from which you receive dividends that are taxed only once. After you have received sufficient income from the business to reach your financial-security goals, you then transfer, by gift or sale, the remaining stock to your related party.

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This is only one of several techniques you can use when you are selling or transferring ownership in an S corporation to your child or key employee. In all such situations, operating your company as an S corporation facilitates the transfer of the business at the lower total tax cost to you and to the business.

Conclusion

The original editorial plan for this white paper was to do the following:

1. Find and describe the advantages of using a C corporation for owners who seek to exit their businesses.
2. Find and describe the advantages of using an S corporation for owners who seek to exit their businesses.
3. Contrast the two business forms.
4. Ultimately conclude that one was more favorable than the other.

Unfortunately, research and experience did not permit this type of analysis. When you consider your business *exit*, there is simply no case to be made for doing business as a C corporation. This is true whether your wish is to transfer the business to children, key employees, or third parties. It is true whether you plan to exit your business in 10 days, 10 months, or 10 years.

The principal advantage of doing business as a C corporation—lower initial income-tax brackets than your personal bracket—is far outweighed by the disadvantages of a C corporation when it comes time to sell your successful business.

The bottom line is this: If you are planning on exiting your business, meet with your tax advisor and discuss the advisability of conducting business as an S corporation or other tax flow-through entity **today**. Failure to do so will allow the IRS to take more money in taxes than absolutely necessary from the sale of your business. While we would all like to see a reduction in the federal deficit, we don't want you to be the one paying it down through the sale of your business. Please contact us today for more information on how a corporation conversion can reduce your tax obligations.

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