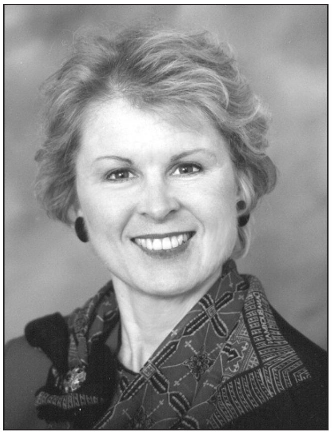
BusinessAdvisor

a resource for business owners

FROM THE LAW OFFICE OF MARY HANSON

VOLUME 28
NUMBER 4
APRIL
2012



Mary Hanson

About the BusinessAdvisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

Mary Hanson has a law degree from the University of Wisconsin and an MBA from the University of Southern California. She has practiced business law exclusively for more than 30 years.

She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

Her interests include flying and World War II.

Her law office is located in the Del Amo Financial Center, 21515 Hawthorne Blvd. #885, Torrance, California. She can be reached at (310) 543-1355 or by e-mail at mhanson@bizadvisor.com

WHAT EVERY BUSINESS OWNER SHOULD KNOW ABOUT C CORPORATIONS AND S CORPORATIONS

by Mary Hanson

Over the past 20 years the S corporation has become the typical first choice of an entity for an active operating business with few shareholders. Many existing C corporations have converted to S corporation status, and many C corporations have considered a conversion to S corporation status but found the tax consequences of a conversion to be prohibitively expensive. Some C corporation owners have found out "too late" that conversion to S corporation status at an earlier date would have been beneficial.

Despite the popularity of the S corporation, I find business owners (both S corporation shareholders and C corporation shareholders) are not as familiar or aware as they should be of the differences between S corporations and C corporations and what the benefits, limitations, and challenges are for each.

The best understood feature of the S corporation is the "pass-through" tax treatment or "one level of tax." The S corporation avoids the "double taxation" of the C corporation, since the S corporation taxable income is reported on the tax returns of the individual shareholders and the tax is paid by the shareholders, not the corporation.

Instead of the corporation paying taxes on its taxable income and capital gains, the corporation files an "informational tax return" and the actual tax consequences of the activities of the corporation (including losses) are passed through to the shareholders according to their percentage ownership interests.

Business owners establishing a new entity most often want the pass-through tax treatment, and select the S corporation, or, if the S corporation is not available because of the requirements for S corporation status, they select an alternative entity that is subject to similar pass-through tax treatment.

A business owner who has a C corporation (a regular corporation that has not elected S corporation status) should plan ahead and consider what the tax consequences would be of selling or winding up the business as a C corporation. He or she should understand the impact of the C corporation's double taxation on the net proceeds of the typical sale of the business. Too many business owners are surprised to find out that the capital gains taxes at both the entity level and the individual level will consume more than half of the purchase price offered for their businesses.

By knowing how the two levels of tax work, the business owner can plan ahead and either work to make the corporation saleable as a corporation, or look at options such as conversion to S corporation status, after weighing the burdens caused by such a conversion.

The S Corporation

Some of the most important issues regarding S corporations are:

- An S corporation cannot have shareholders that are partnerships, corporations, non-resident aliens, and some types of trusts.

"Conversion of an existing C corporation to S corporation status presents tax challenges that can be complex and burdensome."

- An S corporation cannot have more than one class of stock.
- There are a variety of other limitations on S corporations, and these need to be reviewed to see if any of them prevent the election of S corporation status. A corporation is "ineligible" for S corporation status if it does not meet the requirements. A regular for-profit corporation is a C corporation if it doesn't elect (or it loses) S corporation status.
- Conversion of an existing C corporation to S corporation status presents tax challenges that can be complex and burdensome. A conversion can result in substantial taxes at the time of conversion and for a number of years after the conversion.
- After a C corporation converts to an S corporation, the S corporation must pay entity-level taxes on "built-in gains" related to value built up by the corporation when it was a C corporation if after the conversion the corporation has profits and disposes of pre-conversion assets. The S corporation normally has to pay this additional (and high) built-in gains tax on its gains recognized in the 10 years after the conversion. (In recent years temporary relief from this built-in gains tax was extended to existing S corporations that converted from C corporation status less than 10 years before.)
- After a C corporation has converted to an S corporation, the S corporation faces a special tax on passive investment income (defined as rents, dividends, interest, annuities, and sales or exchanges of stock) and the S corporation faces automatic termination of its S corporation status if such passive income exceeds 25% of its gross income for 3 years and it has during the same 3 years undistributed "earnings and profits" from when it was a C corporation.
- The limitations on S corporations that have converted from C corporations are to prevent C corporations from electing S corporation status and avoiding two levels of tax upon the sale of the corporation's business and dissolution of the corporation. The taxes do this effectively, and a business owner cannot expect to convert a C corporation to an S corporation to avoid taxes resulting from the sale or liquidation of the business.
- Changes in the corporation or its shareholders that make the corporation ineligible for S corporation status will cause the automatic termination of the corporation's S corporation status.
- If an S corporation's S corporation status is terminated (voluntarily or as a result of loss of eligibility), in addition to any undesirable consequences at the time of the termination, the S corporation generally cannot re-elect S corporation status for 5 years.

C Corporation Comparison

Understanding the "flow-through" characteristic of the S corporation is clearer when compared to the tax treatment of the C corporation. In the C corporation, taxable income and capital gains are taxed at corporate tax rates paid by the corporation. The rates differ from personal rates, with the brackets and the rates being quite different and the rates typically being higher.

The income of a C corporation is "taxed twice" by the time it is distributed to shareholders. Taxable income is

WHAT EVERY BUSINESS OWNER SHOULD KNOW ABOUT C CORPORATIONS AND S CORPORATIONS

reported on the tax return of the corporation and paid by the corporation. Shareholders don't report any part of the corporation's income or losses on their tax returns, but shareholders pay taxes on the dividends paid to the C corporation shareholders. When shareholders pay taxes on the dividends, it is said that the same profits of the corporation are taxed twice.

Double taxation is most burdensome and problematic for business owners upon the sale and liquidation of a business that is (or was) operated as a C corporation.

A common frustrating situation is where the business of a C corporation is sold at a good price as a sale of assets (not the sale of the corporate stock). If the business is profitable and desirable, the corporation's assets are typically sold at a price substantially above book value, and the corporation's taxes from gains, depreciation recapture, and other tax consequences are typically a high percentage of the purchase price.

When the funds received by the corporation from the sale of assets are distributed to the shareholders as a final distribution, the shareholders of the C corporation pay capital gains taxes. The final distribution or "liquidating dividend" from the corporation is treated as a payment for the shareholders' shares of corporation stock and each shareholder receiving a distribution pays a capital gains tax as if he or she sold the corporate stock for a price equal to the distribution. If the business owner started the corporation with a small payment for shares of stock the difference between the shareholder's basis in the stock and the amount of the distribution (the capital gain) can be substantial. So the second level of tax "on the same transaction" – the sale of the business – is another substantial tax. The calculation of the combined taxes can cause a business owner to conclude that he or she "can't afford to sell." Higher personal capital gains taxes would make the impact even greater.

The two levels of tax need to be considered even in the dissolution of a C corporation. When a C corporation is dissolved, the corporation is still subject to income or capital gains taxes on the sale or disposition of its assets. The sale or other disposition of assets that have been depreciated or written off (and have little or no book value) subjects the corporation to potentially significant taxes. The distribution of the C corporation's remaining after-tax funds to a shareholder subjects the shareholder to capital gains taxes if the amount exceeds his or her tax basis in the stock – typically the amount he or she paid for the stock.

Any business advisor who has struggled with the issues of double taxation will urge the business owner to elect S corporation status at the time of incorporation. The early election avoids the eventual double taxation upon sale or liquidation of the business, and also avoids the burdens the corporation suffers if it converts from a C corporation to an S corporation.

Other Considerations

A business owner selecting an entity needs to consider the full range of features of the various types of entities, and consider the various benefits and disadvantages. One key disadvantage of S corporations (and other pass-through entities) is a limitation on the deductibility of fringe benefits, such as life insurance, health insurance, medical expense reimbursement and death benefits, which would be deductible employee benefits to a C corporation shareholder who is also an employee of the corporation.

"The best understood feature of the S corporation is the 'pass-through' tax treatment or 'one level of tax.'"

Publisher's Note

The descriptions of tax advantages and challenges of the S corporation in this article are very simplified. It does not cover any aspect of state law. In fact, California does impose a tax on S corporations at the corporate level (at 1.5% of taxable income), and the state minimum franchise tax ($800) applies to both S corporations and C corporations, regardless of whether the corporation has any taxable income.

Tax law related to S corporations has become very complex and requires good tax knowledge, good accounting, and adequate financial records in order to determine appropriate taxes and avoid paying more tax than necessary.

A C corporation shareholder contemplating a conversion of the C corporation to S corporation status will need the assistance of a very capable CPA. A conversion is simply inadvisable without a very thorough understanding of the immediate and future tax impact of the conversion.

Mary Hanson
Attorney/Publisher

Another potential problem for an S corporation shareholder (as well as an owner of an interest in any other type of pass-through entity) is that shareholders can be subject to high taxes on high reported taxable income despite the lack of distributions from the entity. If profits are reinvested in the business (rather than distributed to shareholders), the shareholder taxpayers have to come up with their own funds to cover the taxes resulting from the S corporation income reported on their tax returns. If other personal income places an S corporation shareholder in the highest tax brackets, the tax rates applicable to additional income and gains attributable to the S corporation (or other pass-through entity) will be the highest rates.

There are similar pitfalls when the entity's income is used to pay down debt. For example, if all the profit of an S corporation (or other pass-through entity) is used to pay off a $100,000 line of credit in one year, that non-deductible payoff will boost the S corporation's (or other entity's) taxable income for that year by $100,000, and the S corporation's shareholders (or the LLC's members or the partnership's partners) will have to come up with funds to pay their taxes resulting from the additional $100,000 of taxable income. The shareholders are liable for the tax whether or not they received any funds from the corporation.

For shareholders not involved in the business, the income and losses from the business are passive, and if the S corporation shareholder does not have personal passive losses with which to offset passive income (or passive income or gain against which to offset passive losses) the tax situation can be undesirable. BA

BusinessAdvisor
a resource for business owners
FROM THE LAW OFFICE OF MARY HANSON
21515 Hawthorne Blvd. • Suite 885 • Torrance, California 90503 • (310) 543-1355

RETURN SERVICE REQUESTED