‘C’ VS. ‘S’ CORPORATION

WHITE PAPER

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“I expect to exit my business down the road, but is there anything I need to do *now*?” Business owners often express this concern because, as they do nothing to prepare for their eventual departure, they suspect that they should. These owners are on to something.

Every owner will *someday* exit his business. Far too many owners delay planning for this departure until that *some*day suddenly becomes *to*day. Since busy business owners are extraordinarily adept at ignoring the planning necessary to exit their businesses, only the most motivated owners spend time or money planning for their departures.

I hope that this White Paper will motivate you to undertake some planning because to delay all exit planning may well *double the taxes* you will owe upon the business sale.

The Exit Planning that you must discuss with your advisors and must act upon far in advance of your anticipated exit:

- Is elementary;
- Is simple to execute; and
- Has little impact on the character or conduct of your business.

The specific planning issue that we will discuss here is the careful consideration of how you wish your business income to be taxed.

Do you want business income taxed to you directly? If so, your business form or entity should be an S Corporation, an L.L.C. (a limited liability company), sole proprietorship, or partnership.

Or, do you want the business income taxed to the business? If you prefer this choice, then you will conduct business as a C Corporation.

It is difficult to imagine a more elementary decision, one made initially when you begin your business and often 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 the owner to minimize any current tax on business income. Consequences—harmful or beneficial—arising from your choice of business entity, come crashing down when you decide to exit the business. That’s when the rubber really meets the road—and that’s when operating under the wrong tax entity suddenly

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has all the appeal of an oncoming Mack truck—in your lane.

For example, if you decided to take advantage of the lower tax rates of a C Corporation during the start up and growth years of the business, you'll suddenly discover that selling its assets results in a tax on all of the gain at the company level. The large amount of income cannot be juggled from the company to you—it stays in the company—and is taxed accordingly. It is this consequence that can more than double the taxes that must eventually be paid. Why? Because you still don't have the proceeds—the company does. 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 ten years prior to a sale); a choice that ultimately paves the way around the IRS's Mack truck and lets you arrive home with as much of your money in your pocket as possible.

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

The best entity for tax purposes during a business's start up and operational years is often a C Corporation; yet the C Corporation is the worst entity (causing most of the tax problems) when it comes time to sell the business. Conversely, the best tax form at the time of a sale—an S Corporation—is often a poor choice for tax purposes during the operational and growth years of a company.

Let's examine this issue of "C vs. S Corporation" with the help of Chuck Ramsey, a hypothetical business owner.

A STITCH IN TIME SAVE NINE (HUNDRED THOUSAND DOLLARS)

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

That was the conclusion Chuck Ramsey and his financial advisors reached after careful analysis. Given that Ramsey's accountant conservatively valued his software design company at about $4 million, Chuck's goal was realistic. Chuck anticipated 20 percent capital gains tax (15 percent federal and 5 percent state) netting him over $3 million. He was ready to sell when he first met his deal attorneys.

They reviewed Ramco's financial statement and noted two significant items. First, there were not a lot of hard assets. As a service company, most of the purchase price would be

paid for "goodwill" (an asset without any basis). Secondly, they found that Ramco was organized as a C Corporation. The attorneys and CPAs suggested to Chuck that this entity choice would prove to be a major stumbling block because any buyer would want to buy the assets of Ramco, not the stock. As a C Corporation, he should expect the total tax bill to be closer to $2 million.

Chuck immediately responded, "How could we have been so wrong?" Wondering whether he referred to his business attorney, to his accountant, or to himself, his advisors offered this explanation.

"Chuck, most buyers of your company will want its assets. Since Ramco is a C Corporation, there is a tax imposed, at the corporate level, on the sale of those assets. When Ramco receives the $4 million, it is taxed on the difference between that $4 million and its basis in the assets being sold. At most, Ramco'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 percent (35 percent federal and 5 percent state), Ramco will pay over $1 million in taxes. When you, in turn, receive the $3 million from Ramco there will be a second tax—a capital gains tax—on that gain. That 20 percent 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 but a little over $2 million—well short of your goal."*

On the other hand, if Ramco were an S Corporation, most of the $3 million gain ($4 million sale price minus $1 million basis) would be taxed once at capital gain rates.

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

$4 million Fair Market Value of Business *Sale of Assets*			
	Tax-Corp	*Tax-Personal*	*Net proceeds to owner*
C Corp	$1 million	$750,000	$2.250,000
S Corp	$0	$900,000	$3,100,000

Obviously, Ramsey failed to choose the entity that would perform best (from a tax standpoint) when he sold his business. Had Ramco 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 gain rates. The average of all the various rates is about 25 percent.

So, what's the difference between a C Corporation and an S Corporation? Given a $4 million sale price, the difference is another $1,000,000 or so into Chuck's pocket instead of the IRS's. As mentioned earlier, however, the entity choice that best suits doing business may

not be the best form for selling the business. How, then, does a business owner decide? Perhaps by asking his or her tax advisors?

Question most CPAs as to what business form they suggest for the business clients and they typically answer, "A C Corporation—at least in the early capital formation years of the business."

What difference does it make?

Ask any Investment Banker or other Transaction Advisor what entity they prefer and you will likely hear, "An S Corporation or LLC (Limited Liability Company), or perhaps a partnership or sole proprietorship. Anything, *anything*, but a C Corporation!" Whose advice do you follow? More importantly, how do you decide what is the best form of business for you? Let's begin by looking at the income tax features of both the regular corporation and the various flow-through entities.

TAX ATTRIBUTES OF A C CORPORATION

A C Corporation enjoys income tax brackets separate from those of its owners. For the first $50,000 of taxable income retained in the corporation, the federal tax bite is 15 percent. The next bracket applies to $50,000 to $75,000 of retained taxable income and imposes a 25 percent tax rate; from $75,000 to $100,000 the rate is 34 percent; and above $100,000 an additional five percent tax applies to phase out the benefits of these graduated rates. The capital gain rate is a flat 34 percent.

Most businesses, at least in their infancies, need to retain earnings at the business level to fund expansion. For this reason, the C Corporation form may be best because it pays less tax, especially on the first $100,000 of annual retained earnings, than an individual or flow-through entity. Thus, C Corporation status offers significant benefit to a growing business. But beware of simple solutions.

The C Corporation's greatest attribute can 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 percent and will likely be less depending upon the basis in the assets sold.

Next, however, 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 percent and you will pay any state tax that applies. Alternatively, you might wish to liquidate the C Corporation and use the lower capital gain 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 Ramco 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 not a 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 gain on the net gain. The owner, then, avoids the second tax which is incurred when a C Corporation distributes the net proceeds to its owners, and takes advantage of the much lower personal capital gains rate of 15 percent, rather than the C Corporation rate of 34 percent.

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. Also, 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.

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 the C from the S Corporation. Limited liability is attainable in both the C and S Corporation forms. Voting rights need not differ. An S Corporation conducts business, on a day-to-day basis, exactly as a regular 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.

There are, however, some limitations on the type of shareholders permitted 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 S Corporation flow through to the owners of the S Corporation like a partnership. Thus, when an appreciated corporate asset, like good will, 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 regular corporation during its formative years in order to take advantage of the lower income tax brackets, which in turn lead to the faster accumulation of capital within the company. When the business is sold, however, the S Corporation form 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. Too well, noticed the IRS, in depriving it of tax revenue.

So the IRS changed the rules. Today, if a regular corporation converts to S status, a ten-year "built-in gain rule" is applied to maximize the tax revenue to the IRS. The built-in gain 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 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 gain existing on the conversion date to S status on assets owned by the former C Corporation. The built-in gain on those assets is taxed if those specific assets are sold during the ten years following the conversion. Any assets carried over from C status may be subject to the November 1997 Page 4 built-in gains tax. These assets include furniture, equipment, land, securities, as well as 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 (the built-in gain) then in existence on the conversion date and which is realized when the asset is sold.

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

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

A sale during the ten year built-in gain period will not result in a double tax if you can establish that the *appreciation* in the asset occurred *after* the conversion date; hence the importance of an **early conversion, competent tax advice**, and an **appraisal** or valuation that can withstand the scrutiny of your friends at the Internal Revenue Service.

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 THE 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. Sell assets and pay a single tax (at the individual level) on the gain from the sale.

Option 2. Sell stock. 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 gain 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 once 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 during previous years. This upward basis adjustment 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 stock for the stock of the acquiring company. Structured properly, this is a tax-free merger with you, the owner, 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 S Corporation owner remove cash and other liquid assets from his business equivalent to his basis immediately prior to the sale. This results in a tax-free distribution of cash from the business to the owner. A merger is then based upon 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 but a single tax on the unrealized gain the owner receives as a result of the sale.

SALE OPTIONS FOR THE C CORPORATION

Remember, the double tax consequences of an asset sale by a C Corporation are typically disastrous, often 40 percent (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 CRT. With proper planning, an owner can *avoid all tax consequences* at the time of sale.

Briefly, the steps are:

1) create a charitable remainder trust (CRT);
2) transfer the stock to the CRT;
3) have the CRT enter into an agreement and sell the stock to a third party. (If this is of interest to you, we have a White Paper on the use of Charitable Remainder Trusts in Exit Planning.)

Option 3. Merge with the buyer's company. Again, there is no tax due at the time of the merger. Eventually, capital gains tax 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 onto 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 at the date of your death. This approach is not recommended for owners who wish to spend money (however diminished by taxes) before their deaths.

Option 5. Convert to an S Corporation. This conversion will be subject to the built-in gain rules previously discussed. Although the built-in gain rule is a ten-year rule, much can be achieved by converting to an S Corporation a few years before the sale.

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

Assume Ramco's assets were valued at $2 million (with $1 million basis) at date of conversion (January 1, 2005) and the business sold for $4 million on January 1, 2009. The tax consequences look like this:

$4 Million Fair Market Value of Business			
	Tax Corp	*Tax Personal*	*Net Proceeds*
$2 million C Corp (Built-in Gain)			
	$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 consequence 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 a Limited Liability Company or partnership) acquire equipment, real property, or other assets (such as intellectual property rights, patents, copyrights, etc.) that your business uses to operate. When the business and the 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 corporate level.

For example, assume Ramsey created an LLC for assets used by Ramco 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			
	Tax-Corp	*Tax-Personal*	*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 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: a covenant not to compete, consulting agreement, employment agreement or licensing or royalty agreement directly with you. The double tax bite is avoided at the cost, however, in the case of employee-based compensation, 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.

TRANSFERRING A BUSINESS TO FAMILY MEMBERS OR KEY EMPLOYEES

This Paper has highlighted several advantages available to entities other than regular C Corporations when selling a business to an outside third party. But 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 that "greater advantage" is 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 your

key employee, 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 buy-out money is the *future income stream of the business*. Given this overarching consideration it is imperative that the business's future income be transferred to you with the least tax loss possible. An asset or stock sale involving a C Corporation causes the business's income stream to be reduced twice by taxation: 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.

But, why when *selling stock* to your child (or employee) do we need to be concerned with two levels of tax? 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). She 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 her for the purchase of your stock.

The solution to avoiding the double tax bite (whether asset or stock sale) involved in a sale to a related party, 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 but 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.

This is but 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:

- First, find and describe the advantages of using a C Corporation for owners who seek to exit their businesses;
- Second, find and describe the advantages of using an S Corporation

for owners who seek to exit their businesses; and.

- Third, contrast the two business forms and;
- Ultimately conclude that one or the other was more favorable than the other.

Unfortunately, research, and experience, did not permit this type of analysis. Why? Because 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, to key employees, or to outside third parties. It is true whether you plan to exit your business in ten days, ten months, or ten years.

The principal advantage of doing business as a C Corporation—initially lower 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 now with your tax advisor and discuss the advisability of conducting business as an S Corporation or other tax flow-through entity. If you choose to delay this all-important decision, we thank you, in advance, for your contribution to reducing the federal budget deficit.

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