Choosing the right business entity

How to balance owner objectives with business objectives **Interviewed by Leslie Stevens-Huffman**

When launching a new business venture, you must decide what form of business entity will provide the greatest tax savings and the best return to owners and investors.

An initial public offering (IPO) is often regarded as the coveted prize at the end of the rainbow for many entrepreneurs, so the firm is structured as a C corporation. But upon reaching success, many businesses are sold before going public. Structuring as a C corporation might eliminate some of the tax advantages that could be realized in the short term as an S corporation or a partnership, and it may result in double taxation when the business is sold, says Brad Graves, partner-in-charge of the Tax Group at Haskell & White LLP.

"Many entrepreneurs are leaving benefits on the table when they assume that an IPO is the endgame they seek, when a partnership structure might provide the best tax benefits today without diminishing the end result tomorrow," says Graves.

Smart Business spoke with Graves about the tax advantages of the various business entities.

Brad Graves
Partner-in-charge, Tax Group
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How do C corporations, S corporations and partnerships differ in flexibility?

For C corporations, income and losses are reported and taxed at the corporate level and profit distributions are generally characterized as dividends. There's no deduction for profit distributions at the corporate level, because dividend income is allocated to the shareholder who recognizes the dividend at fair market value when reporting it for individual income tax purposes. Any noncash distributions trigger a gain at the corporate level.

As S corporations, a business's income and losses are passed through to the shareholder level and allocation is equal for all shares. Noncash distributions trigger a gain at the corporate level that is then passed through to the shareholders. However, this increases the shareholder's stock basis, which will eventually offset future income or generate a loss when the stock is sold.

As a partnership, a business's income may be allocated among the partners with various preferences, guarantees and tranches in order to reflect the agreed upon economic sharing of the partners, as long as certain safe harbor provisions are met. In addition, noncash distributions do not generally trigger a gain.

What are the differences in taxation of operating income between the three?

C corporations are taxed on operating income at the corporate level, which can climb up to the maximum federal rate of 35 percent, and the lower capital gains tax rate does not apply for corporations. Capital losses are allowed up to the level of capital gains and can be carried forward five years or backward three years.

In S corporations and partnerships, all income is passed through and reported and taxed at the shareholder or partner level. Capital gains and losses are taxed at the shareholder's or partner's capital gain rates and subject only to the limitations at the shareholder or partner level.

What is the difference in how business losses are treated?

If you think that the business will be generating losses, at least for a while, it's important to consider how they will be treated for tax purposes. For C corporations, losses may only be carried over at the corporate level. While S corporations pass losses through to the shareholders to the extent of stock basis, plus basis in shareholder loans to the corporation. However, if the firm will be heavily leveraged, a partnership may be preferable. Partnerships can utilize losses in much the same way as S corporations. Losses pass through to the extent of basis in partnership interest (capital account plus allocable share of debt, including debt from banks and other third parties) with one caveat that 'at-risk' limitations will limit losses funded by nonrecourse debt unless it is 'qualified.'

How do the three entities differ in the tax implications resulting from the sale or liquidation of the business?

A sale or liquidation of the assets by a C corporation results in double taxation. The corporation realizes gain or loss from the sales of the assets, pays corporate income taxes and distributes the remaining assets to the shareholders, who will be taxed on the proceeds they receive.

The S corporation is regarded as a 'single-taxation' entity when the business is sold, so gains or losses resulting from the sale are passed through to the shareholders, who report the income and losses and pay the taxes. Stock basis is increased, thereby reducing gain on stock redemption.

In the event of a liquidation of a partnership by distribution of the assets to the partners, no gain or loss is generally recognized — so there's no tax. In the event of a sale of the partnership's assets, gains and losses at the partnership's level are passed through to the partners, who report the income and losses and pay the taxes. The partners' bases in their partnership interest receive a corresponding increase or decrease, thus ensuring only a single level of taxation.

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