Revisiting the Choice of Entity Decision for the Closely Held Business

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During the past year, numerous articles have summarized and analyzed the changes made by the Tax Cuts and Jobs Act (the "2017 Tax Act"). Both the adoption of the 21% flat corporate tax rate and the 20% qualified business income deduction have attracted attention, along with a number of other tax law changes that affect closely held businesses. Now with the benefit of the passage of time, we can shift our focus from understanding what has changed and how it works to consider whether these changes have significantly altered the choice of entity landscape.[i]

1. Should the C corporation now be the default entity choice for the closely held business?

No – for the reasons outlined below, pass-through entities such as LLCs (taxed as partnerships) and S corporations remain the entity of choice unless a business plan fits squarely within the **C Corp Business Model** described below. The bottom line is that the aggregate federal income taxes paid by a closely held business and its owners if a closely held business is operated as a C corporation almost always exceed the taxes paid if the business is operated through a pass-through entity. At the end of this article, there is an appendix called "crunching the numbers" that approaches the choice of entity issue as a number-crunching exercise. Although results of exercises like these are always driving by key assumptions, the exercise does confirm that under a narrow set of circumstances referred to below as the **C Corp Business Model**, the C corporation proves to be the superior choice for the closely held business. But outside of those narrow set of assumptions, the pass-through entity remains the entity of choice. Although it is difficult to quantify for purposes of the exercise, a key factor that should be considered in the choice of entity analysis is how risky it is for planning purposes to assume that the assumptions

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underpinning the choice of the C corporation can, in fact, be achieved. The numbers suggest that if business owners operate their business through a C corporation and ultimately fail to qualify for the best-case scenarios afforded by the **C Corp Business Model**, the financial results can fall well below those achieved by operating the business through an LLC.

Exploring the C Corp Business Model – is the C corporation a viable entity choice now that there is a 21% flat corporate tax rate?

The 2017 Tax Act reduced the federal corporate tax rate from a graduated rate topping out at 35% to a flat 21% rate. Does this 21% tax rate change the usual recommendation that owners of closely held businesses should operate through a pass-through entity?

"Yes" in a narrow and very qualified set of circumstances. The C corporation would be the best choice for a closely held business if the business plan fits precisely within what I refer to as the **C Corp Business Model**. For owners of a closely held business, the C corporation would be the correct entity choice if:

- the business owners are able to limit the amount of compensation and dividends paid to the owners to a minimum. Each dollar paid out as compensation is taxed at a higher tax rate. Dividend income is usually subject to double taxation. In either case, the benefit of the 21% rate is lost;
- the profits generated by the business must be gainfully reinvested into growing the business. If the profits are merely invested by the corporation in passive investments, the personal holding company tax or accumulated earnings tax may come into play, which in either case would undermine the benefits of the 21% rate;
- the C corporation's stock qualifies for favorable Section 1202 (QSBS) treatment;
- the C corporation is operated as a qualified small business for a little more than five years and then the owners successfully sell their QSBS; and
- when the owners sell their QSBS, they find a buyer who won't discount the price even though the stock purchase (in

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contrast to an asset purchase) won't trigger an inside basis step-up for the buyer. A basis step-up allows the buyer to amortize for tax purposes the purchase price paid for the business.

It is true that business owners will generally end up with more dollars in their pocket if they can fit within the **C Corp Business Model** and operate their business as a C corporation. Generally, $10 million of gain on the sale of an owner's QSBS escapes taxation under IRC § 1202. Other benefits of selling QSBS include avoiding employment taxes, avoiding the 3.8% net investment income tax, avoiding the individual alternative minimum tax, and in many states avoiding state and local income taxes. Obviously, a very attractive tax result if it can be achieved. As discussed in detail below, while the benefits of qualifying for the **C Corp Business Model** are real, there are few business plans for closely held businesses that will comfortably check off each of the factors outlined above.

If the benefits outlined above aren't enough, there are additional benefits associated with operating through a C corporation, but these benefits generally won't themselves move the dial away from selecting the pass-through entity:

- after the 2017 Tax Act, C corporations are no longer subject to an alternative minimum tax;
- the 2017 Tax Act's $10,000 limitation on an individual's deduction of state and local taxes doesn't apply to C corporations;
- only C corporations and S corporations are able to participate in tax-free reorganizations under IRC § 368, LLCs taxed as partnerships are in most respects excluded from participation;
- the risk of "phantom income" that is always a concern for owners of an interest in a pass-through entity doesn't apply to C corporation shareholders. In the case of foreign and tax-exempt investors, the allocation of income to them by a pass-through entity exposes them to U.S. taxation requiring the filing of a U.S. tax return. When a pass-through entity is used, these investors often hold their interests through "blocker" C

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corporations;

- there is generally no U.S. tax liability for foreign and tax-exempt investors selling C corporation stock. The sale of the assets or equity of a pass-through entity will also often result in U.S. taxation of the foreign investors and the triggering of withholding obligations;
- the sale of corporate stock with a long-term holding period will generally qualify for long-term capital gains treatment. The sale of a partnership interest often results in the gain attributable to "hot assets" (e.g., accounts receivable; depreciation recapture; inventory) being taxed at ordinary income rates; and
- finally, C corporation shareholders aren't required to file tax returns in states where the company does business (which contrasts with the treatment of owners of pass-through entities).

The 2017 Tax Act also added several international tax benefits only available to corporations, such as the 100% dividend received the deduction for 10% owned foreign corporations and a reduced effective tax rate on foreign-derived intangible income. This article does not focus on international tax considerations. But if a business will receive a meaningful volume of income from foreign sources, international tax planning should certainly be considered in the choice of entity analysis.

Looking at the assumptions underpinning the C Corp Business Model and other C corporation planning points.

As mentioned above, operating a business through a C corporation results in best-case tax treatment given the 21% rate and capital gains on the sale of C corporation stock, but only if everything works out as planned. As the discussion below illustrates, best case tax results can quickly turn into worst-case tax results if the assumptions that favor the **C Corp Business Model** aren't achieved:

- one of the key assumptions for the **C Corp Business Model** is that the owners won't require the company's earnings to be paid out as compensation or dividends during the operating

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years. If a C corporation's earnings are paid out as dividends to individual owners, the income will be subject to double taxation (i.e., the 21% corporate rate, plus the 20% qualified dividend rate, plus in some cases the 3.8% net investment income tax). If the owners take cash out as compensation payments, revenues that would have been taxed at the 21% rate are instead taxed at a higher individual rate and are further subject to employment taxes. Another assumption underpinning the **C Corp Business Model** is that the company's revenues will be needed to grow the business and that more after-tax revenues mean more money to grow the business. More after-tax dollars may mean less expensive borrowing is needed to grow the business. In most but not all cases, the lower corporate rate should propel the growth of the business and result in more proceeds when the business is sold. Having more after-tax dollars to reinvest back into the business during its early years may be less of a factor for some businesses than others.

- since many businesses don't have owners who can forgo the extra cash-flow from their company, this tax rate leakage might be a problem for achieving the C Corp. Business Model. One possible planning approach to accommodate the owners' need for cash during the operating years is to include owner financing in the corporation's capitalization, which should work as long as the loans pass muster under the IRS' debt versus equity rules. But the distribution of after-tax proceeds to repay loans won't help grow the business, which as discussed above, is a critical part of the success of many businesses;
- the **C Corp Business Model** assumes that most of the company's cash flow will be gainfully plowed back into the business, avoiding the threat of additional taxes imposed by the accumulated earnings tax (IRC §§ 531 – 537) or the personal holding company tax (IRC §§ 541 – 547). These taxes are intended to penalize C corporations that unnecessarily avoid distributing earnings to owners. A business that can't be effectively grown using the additional after-tax proceeds resulting from the 21% corporate rate isn't a good candidate

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for the **C Corp Business Model**;

- the linchpin of the **C Corp Business Model** is the complete avoidance of tax when the business' stock is sold. To achieve this result, the C corporation's stock must qualify as qualified small business stock (QSBS) under IRC § 1202. Under IRC § 1202, a shareholder escapes taxes on at least $10 million of gain on the sale of QSBS if the shareholder has at least a five-year holding period in the stock. If there isn't any tax at the shareholder level when the stock is sold, the only federal tax on the income of the business will be the 21% tax on the operating profits at the corporate level. The problem with making a choice of entity based on the expectation that the owners will qualify for Section 1202 gain treatment, however, is that there are numerous requirements for QSBS qualification. QSBS must be issued for cash, other property or for services, the original buyer must generally sell the QSBS, the corporation must continually principally engage in an active business (as defined in IRC § 1202), which excludes certain types of business activities and entity value limitations applicable at the time of issuance, there is generally $10 million cap per taxpayer on the aggregate Section 1202 gain exclusion for anyone issuing corporation (or 10X a taxpayer's capital invested in the C corporation, if greater), and the QSBS must be held for five years for Section 1202 treatment (unless the Section 1202 gain is rolled over into another corporation's stock under IRC § 1045) to apply when the QSBS is sold;
- the **C Corp Business Model** assumes that a business will be operated for five or more years and then sold, taking advantage of IRC § 1202's gain exclusion. But what happens if plans change and the business isn't sold or the plan at the outset is to own and operate the business for an indefinite period? The absence of a credible plan to operate the business for some limited period (say five to 10 years) and then sell creates a problem from a planning standpoint for choosing the C corporation. First, the benefits of the 21% corporate rate will be diluted if the owners need to flush cash out of the business through compensation payments or dividends. As previously mentioned, the greatest benefits are

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reaped when profits plowed back into the business and the owners shield their gain under IRC § 1202. After-tax profits not reinvested in the business won't grow the value of the business and the owners' stock for IRC § 1202 purposes. Obviously, shareholders who don't sell their stock don't benefit from IRC § 1202. If the ultimate exit involves an asset rather than stock sale, the benefits of IRC § 1202 are reduced but not eliminated. The longer period of time after five years that the business operates rather than sells, increases the risk that the requirements for IRC § 1202 treatment won't be available – the business must meet various Section 1202 requirements during the entire holding period for QSBS. Given all of these potential issues, it is difficult to recommend the C corporation for the purpose of taking advantage of IRC § 1202 where the sale of a business isn't reasonably certain somewhere in the neighborhood of the immediate aftermath of achieving a five-year QSBS holding period. Under those circumstances, a better choice seems to be to operate the business as a pass-through and take advantage of IRC § 199A (if possible) and the continuing benefits of pass-through tax treatment;

- the **C Corp Business Model** relies on an assumption that a buyer won't significantly reduce the purchase price to compensate for the fact that the model requires a stock rather than asset purchase. With a stock purchase, the buyer not only will inherit contingent and unknown liabilities of the business but also not qualify for a tax basis step-up allowing for a write off of the purchase price over 15 years under IRC § 197. There are some buyers, particularly large strategic buyers, who are relatively insensitive to the tax benefits of the step-up and are instead more focused on whether the purchase will be accretive to earnings. Many buyers do, however, consider a stock purchase to be a significant negative factor. At the least, sellers are reducing by some number the potential universe of full-price buyers for the business;
- planning to ensure that stock issued by a corporation qualifies as QSBS should be of critical importance when considering the conversion of an existing business to a C corporation. If

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the business is operating as an LLC or other tax partnership form, the key will be that the fair market value of the property contributed to a newly-formed corporation doesn't exceed the $50 million limit (an IRC § 1202 requirement). If the partnership's assets are contributed to an existing corporation, both the contributed assets and the then-current assets of the C corporation must be taken into account in the calculation and the contribution won't be tax-free under IRC § 351 unless the contributors hold an 80% interest in the corporation after the contribution. The outstanding stock of a converted S corporation cannot be QSBS, but stock subsequently issued by the C corporation can qualify as QSBS. An S corporation can fashion a workaround by contributing assets to a newly-formed C corporation – the stock issued in exchange can qualify as QSBS;

- tax losses won't pass through to a C corporation's owners. Many companies experience tax losses in early years, particularly given the 100% write-offs often available for capital invested into a business. Subject to basis, at-risk and passive loss limitations, partners can use losses passed through on their Schedule K-1 against their other income. One idea is to operate through an LLC taxed as a partnership during the start-up years and convert to a C corporation when and if the business becomes successful. An important note is that when a partnership is incorporated, the $50 million gross assets test for IRC § 1202 qualification purposes (a corporation that goes over that value cannot issue QSBS, but the test only applies at the time of the issuance of the QSBS) will be based on the fair market value of the partnership's assets;
- although the 21% flat corporate rate is advertised as being permanent, Congress could increase the rate. Congress could also reduce or end the benefits of IRC § 1202. The 2017 Tax Act's 20% deduction for a pass-through entity's qualified business income under IRC § 199A is set to expire at the end of 2025;

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- note that changes in the tax laws that affect closely held businesses won't impact choice of entity for companies that must operate through C corporations for regulatory reasons (e.g., banking and insurance companies), or that need to use C corporation "blockers" to avoid the pass-through of income (many foreign owners and tax-exempt owners), or public companies;
- a choice-of-entity truism is that you can convert a pass-through entity to a C corporation tax-free but it is prohibitively expensive from a tax standpoint to convert from a C corporation to a pass-through entity. This statement is true because you can generally incorporate on a tax-free basis under IRC § 351, but the conversion from a C corporation to an LLC is a taxable liquidation triggering a deemed sale of the corporation's assets for tax purposes. An in-between step would be for the C corporation to make an S election, but that election isn't available unless all of the corporation's shareholders are eligible under the S corporation rules (generally limited to US resident individuals);
- both C corporations and S corporation, and their respective shareholders do benefit from being able to participate in tax-free reorganizations under IRC § 368. Entities taxed as partnerships and their owners cannot participate in tax-free reorganizations. For the most part, this is not a factor because it is difficult to foresee when an entity is organized an exit strategy that will rely on participation in a tax-free reorganization. One possible situation would be where a franchisee agrees up-front to a roll-up involving the exchange of franchise assets for stock. In that case, the operation of the franchised business or ownership of LLC interests through an S corporation would be desirable as the exchange of LLC assets for the stock would be taxable, barring the unlikely case that the transaction qualifies for IRC § 351 tax-free exchange treatment;
- in general, the LLC taxed as a partnership and the S corporation remain the entities of choice because of the constant threat of double taxation associated with the

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operation and sale of a business operated as a C corporation. Unless double taxation can be avoided by taking advantage of the exclusion for Section 1202 gain (which includes for planning purposes the rollover of Section 1202 gain under IRC § 1045), the owners of business operated as a C corporation have two choices. They can sell the assets of the business (which is often demanded by buyers in order to avoid the liabilities of the business and to achieve a tax basis step-up for the assets), and be taxed at the 21% rate at the corporate level and then be taxed again at capital gains rates (plus the 3.8% investment income tax) at the shareholder level. A big problem with this approach is that unlike the outside basis of a pass-through entity which increases when operating income is allocated by a pass-through entity (think of the pass-through entity that just makes tax distributions – the owners' outside basis increases each year of operations), the stock basis of a holder of C corporation stock doesn't increase as taxes are paid by the C corporation. This leaves the door open for a substantial tax hit when the business is sold. Alternatively, the business owners can find a buyer for their stock, thereby dodging double taxation on the sale, but often taking a financial hit with buyers who factor the downside of purchasing C corporation stock into the purchase price equation;

- some business owners like the flexibility associated with the governance options associated with the limited liability company versus the corporation form of doing business. For the most part, the governance structure of a corporation involves the use of a board of directors and officers. The LLC can mimic this structure or can use a manager-managed structure, with one or more individuals or entities serving as the manager. The LLC acts allow for the waiver of management's fiduciary duty obligations. The flexibility associated with the LLC form of entity often comes at a cost of additional complexity in terms of the LLC operating agreement's provisions and what advisors need to know with respect to the LLC's tax and governance terms – from a tax standpoint, a partnership is more complicated than a

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corporation. On the other hand, it is possible with multiple classes of preferred and common equity, and complicated capitalization, economic and buy-sell arrangements, to make a corporation just as complicated as an LLC, and in many cases with venture/investor corporate structures, that is what is often seen. A knowledgeable and experienced attorney should be able to basically even the playing field between LLCs and C corporations from a governance and tax structuring standpoint, but if the business owner doesn't have this attorney (and accountants to help with tax and accounting), much more can go wrong with an LLC than a C corporation; and

- from a liability shielding standpoint, owners of LLCs and corporate shareholders should be afforded the same degree of shielding from the debts and liabilities of the business. In practice, the piercing the entity veil analysis found in various state courts may differ depending on whether the business entity is an LLC or a corporation. In some instances, it may be useful to forum shop for a Nevada or Delaware LLC versus other states' LLCs, but there doesn't seem to be any consensus among practitioners whether the corporation or the LLC is the "better" choice from a liability shielding standpoint.

2. Why does the LLC (taxed as a partnership) remain the entity of choice for most closely held businesses?

The main benefit of operating a business through an LLC (for purposes of this discussion, the LLC is taxed as a partnership) is that the income of the business is not subject to double taxation. The taxable income of an LLC passes through to the members who receive a Schedule K-1 and is taxed at the individual member level. In contrast, unless a C corporation shareholder can take advantage of the Section 1202 gain exclusion when the business is sold, C corporations are subject to double taxation if the goal is to get cash into the hands of owners through dividends on in connection with the sale of the corporation's assets. LLC members also benefit from

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a tax basis step-up when they are allocated taxable income. For example, if the LLC earns $100 in 2019 and distributes $35 to pay taxes, the members' tax basis will increase by $65. This basis increase can add up if the LLC operates over a number of years and will be very beneficial if the business is sold. C corporation shareholders do not benefit from any basis step-up because there is no pass-through of gains.

There are other benefits associated with operating a business through an LLC taxed as a partnership:

- Appreciated property can generally be contributed and distributed tax-free from an LLC taxed as a partnership, including distributions of appreciated property in the redemption of LLC units. In contrast, contributions of appreciated property to a C corporation in exchange for C corporation stock that don't meet the requirements of IRC § 351 will be treated as a taxable sale, and almost all distributions of appreciated property are taxable. This lack of flexibility reduces planning opportunities;
- LLCs taxed as partnerships allow for a great deal of flexibility in connection with the tax-favored issuance of incentive equity, including the issuance of "profits interests" under Revenue Procedures 93-27 and 2001-43. In addition, LLCs can issue "carried interests" which allow for the magic combination of no taxation upon issuance, immediate equity ownership and the potential to treat compensation payments as distributions qualifying for capital gains treatment (see new IRC § 1061 which introduced a three-year holding period requirement). C corporations can issue a variety of incentive equity interests and rights, but they don't rival all of the benefits that can be derived from using profits interests/carried interests;
- LLCs taxed as partnerships allow for "special allocations" of profits and losses among partners, giving LLCs flexibility to customize the sharing of tax items and cash distribution waterfalls that doesn't exist to the same degree with C corporations;

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- holders of LLC interests can recover tax basis through cash distributions without triggering dividend tax treatment. In contrast, regardless of how large a shareholder's outside basis is in its stock, a C corporation's cash distribution is generally fully taxable;
- contributing appreciated assets to a corporation on a tax-free basis is relatively inflexible under IRC § 351 which requires that the contributing group hold at least 80% of the corporation's stock post-contribution. In contrast, appreciated property can generally be contributed in exchange for LLC interests without similar restrictions under IRC § 721;
- the holder of an LLC interest is given basis credit for the LLC's debt. This potentially allows the holder to write off losses in excess of the holder's capital investment. S corporation shareholder don't receive basis credit for entity-level borrowing;
- IRC § 704(b) rules generally allow for special allocations of profits and loss to LLC owners. Tax allocations to S corporation shareholders are inflexible (per share, per day allocation);
- the outside basis of LLC owners increases when they are allocated profits if they are allocated $100 of income and distributed $33 to pay taxes on the income, their basis increases by $67;
- appreciated property can generally be distributed out of an LLC tax-free, which contrasts with the deemed sale treatment triggered by a distribution of appreciated property from an S or C corporation;
- it is possible to undertake effective self-employment tax planning when using an LLC, but that planning exercise is easier with the S corporation;
- LLCs don't have any of the owner eligibility issues associated with the S corporation. When an S corporation is used, there is always the issue that the business may want to admit a

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partnership or corporation as a shareholder, either of which would blow the S election. One option when an S corporation is being used is to hold the assets in a disregarded LLC and if there is a need to bring in a disqualified owner down the road, do it at the disregarded LLC level. An S corporation that doesn't have a disregarded LLC subsidiary from the beginning can always undertake a holding company formation (as an "F" reorganization) and turn the operating S corporation into a disregarded subsidiary of the continuing S corporation holding company; and

- the LLC allows for maximum flexibility in distributing cash, allowing for preferred classes of equity. In contrast, the S corporation only permits common equity.

There are some negative aspects of using LLCs as the vehicle through which to operate a closely held business. But most of these problems can be mitigated through thoughtful planning.

- The LLC can cause issues from a self-employment tax planning standpoint.
- LLC owners can have phantom income if cash distributions are insufficient to cover the tax liability created by profit allocations. Investors should reconsider investing in an LLC that doesn't include a required tax distribution unless there is little chance that net taxable income will be passed through to the LLC's owners.
- LLC owners may be required to file state tax returns in multiple states depending on where the LLC does business.
- LLCs and their owners cannot participate in IRC § 368 tax-free reorganizations.

3. Is the C corporation the best vehicle through which to structure a leveraged acquisition?

In today's market, buyers often rely on debt for a high percentage of their funding for M&A transactions. These leveraged acquisitions are structured so that the target company's post-acquisition earnings fund repayment of the acquisition financing. Given the high

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percentage of M&A deals structured as leveraged buy-outs, a fair question to ask is whether the C corporation's 21% tax rate makes it the new entity of choice.

The rationale behind using a C corporation as the vehicle for a leveraged buy-out arises from a comparison of how the C corporation versus a pass-through entity function with respect to repayment of debt. If the buyer is an LLC (taxed as a partnership), then post-acquisition earnings of the LLC will pass through to owners on Schedule K-1s and will be taxed at individual rates (up to a 37% marginal rate), plus any additional investment income or self-employment taxes. Most LLCs will make tax distributions covering the taxes generated by the passed-through net profits. After making the tax distribution and covering the LLC's operating expenses, the LLC will pay down acquisition debt out of the remaining cash revenues. But if the acquisition entity is a C corporation, net profits will be taxed at the 21% corporate rate (rather than up to 40.8%), freeing up more cash to repay acquisition debt.[ii]

The spread between individual and corporate tax rates will make some difference when comparing the cash needs of the LLC versus the corporation. It is undeniable that there will generally be more cash available to pay down debt if the acquisition entity is a C corporation. Plus, using a corporation eliminates the need to negotiate with lenders regarding tax distributions and in some cases will make it easier to deal with lenders and owners in connection with structuring and paying down acquisition financing. We understand that buyers focused on structuring acquisition financing may decide the corporation's favorable 21% rate is enough to make it the acquisition vehicle of choice.

Our opinion is that even where acquisition financing is an important factor of the overall analysis, the C corporation's rate advantage should be viewed in isolation. The other factors going into the choice of entity decision-making process should also be taken into account. For example, we believe that a critical additional factor to consider should be whether the anticipated payoff for the business' owners will be a future stock sale to a buyer who won't discount the price to reflect the tax inefficiencies of a stock rather than asset

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purchase. Along those lines, if the owners' business plan includes owner distributions and compensation, this should be factored into the tax benefit equation. Another factor could be the availability of IRC § 1202's tax benefits. If the acquisition entity's stock will qualify as QSBS, then the C corporation appears to be a very attractive entity choice.[iii]

4. How much does the introduction of IRC § 199A's 20% deduction affect the choice of entity equation?

The 2017 Tax Act introduced not only the 21% flat corporate tax rate but also the 20% deduction for a pass-through entities' qualified business income.

IRC § 199A added a special 20% deduction for income that falls within the category of "qualified business income" from a non-service business (professional practices, financial services firms and businesses where the principal assets of the business is the reputation or skill of employees or owners are excluded from the benefits of IRC § 199A). Qualified business income is generally ordinary income from a business (the deduction isn't available for investment-related income). Qualified business income is reduced by reasonable compensation paid to the taxpayer for services rendered, and the deduction is lost for married couples with taxable income over $415,000 unless the business has sufficient W-2 income or depreciable assets to support the deduction. Also, if the amount of a taxpayer's taxable income is less than qualified business income, this will place a ceiling on the deduction. As the definition of a "qualified trade or business" for purposes of IRC § 199A is derived in part from IRC § 1202, taxpayers will have to weigh the benefits of IRC § 199A (available to disregarded and pass-through entities) against the benefits of IRC § 1202 (available to C corporations) as part of the choice of entity equation.

- For most wealthy business owners or investors, the IRC § 199A 20% deduction will be available against ordinary profits if they hold interests in disregarded or pass-through entities (S

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corporations or LLCs taxed as partnerships) and the business pays substantial W-2 income. Compensation paid to independent contractors, employees of brother-sister entities or in connection with employee leasing arrangements won't give owners the W-2 wage base they need to support the deduction. Restaurants are a good example of a business where the owners should be able to take full advantage of the IRC § 199A deduction.

- From a choice of entity standpoint, the IRC § 199A 20% deduction makes a pass-through entity or disregarded entity relatively more desirable than a C corporation where the deduction is available. Unlike the 21% flat corporate rate, which is straightforward and available to all C corporations, the IRC § 199A deduction is complicated and there are a number of limitations at the taxpayer and the business levels which reduces its availability.
- The fact that the IRC § 199A deduction ends with the 2025 tax year should be kept in mind as part of the planning process. In most cases, the fact that the deduction ends in 2025 shouldn't keep business owners from selecting a pass-through entity if the business doesn't fit within the C Corp Business Model. The business owner can revisit the issue of pass-through entity versus C corporation in 2025 or earlier if desired – the conversion of an LLC taxed as a partnership into a C corporation is generally tax-free, so selecting an LLC taxed as a partnership at the time of business conversion and later converting doesn't carry a substantial tax cost that converting a C or S corporation to an LLC taxed as a partnership often will cause. The conversion of an S corporation to a C corporation can result in triggering of income resulting from the conversion of the business from a cash to an accrual basis taxpayer. Another point that should be kept in mind is that while the incorporation of a partnership can work in terms of issuing stock that qualifies for IRC § 1202 treatment, the assets of the C corporation cannot exceed $50 million at the time of the issuance of QSBS at the time of the partnership's incorporation, including

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the fair market value of the partnership's assets (including its goodwill).

- The fact that determinations with respect to the W-2 wage limitation are made at the business level and whether or not the business is a specified service business has resulted in business owners embarking on the restructuring of their entity structures, which may include consolidating brother-sister entities under one holding company or spinning out a specified service business from a business that would otherwise qualify for the deduction.

5. When is the S corporation a better choice than the LLC (taxed as a partnership)?

Both S corporations and LLCs taxed as partnerships are pass-through entities. In most cases, the LLC allows for the same potential tax benefits as the S corporation without the many potential downsides associated with the S corporation in terms of eligibility, issues with passive income, inflexibility in terms of allocations of profits and distributions of cash (no preferred equity) and no basis credit for company-level borrowing. So, is there ever a situation where the S corporation should be selected instead of the LLC?

- The S corporation creates the opportunity to pay W-2 income to owners, which may give the owners the chance to take advantage of the IRC § 199A deduction (by paying themselves some wages).
- For a single owner entity, some planners may prefer to run expenses through the S corporation's separate return.
- If the business has a single owner, self-employment tax planning can only be accomplished by using an S corporation. All trade or business income on a Schedule C will be subject to self-employment taxes. Running the income through an S corporation return would permit splitting income between compensation and a shareholder distribution (not subject to self-employment taxes), provided that some of the income is generated by capital or the efforts of someone other than the

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owner.

- S corporations qualify for participation in tax-free reorganizations under IRC § 368 (whereas entities taxed as partnerships aren't eligible for tax-free reorganization treatment). Beware of converting a tax partnership into a corporation immediately prior to engaging in a "tax-free" reorganization – the step transaction rules may be applied by the IRS. This issue comes up when there is a desire to roll up an entity taxed as a partnership into a larger entity in exchange for the entity's stock – a transaction that can be structured as a tax-free reorganization if the target is a corporation but must satisfy the IRC § 351 rules if the target is a partnership.
- Shareholders of S corporations may be eligible for IRC § 1244 loss treatment. Partners in a tax partnership aren't eligible for IRC § 1244 treatment.
- Sales of S corporations avoid the "hot assets" look-through issues associated with partnership sale transactions (under IRC § 751).
- Holding raw land in an S corporation permits the sale of the property to a separate brother-sister controlled entity for development purposes, locking in long-term capital gain at favorable rates. In contrast, if the entity holding the land is a partnership, the sale to a related entity would result in ordinary income treatment under IRC § 707(b)(2).
- If a substantial shareholder is an employee stock ownership plan (ESOP), the use of the S corporation will basically allow income allocated to the ESOP to avoid taxation as ESOPs are nontaxable.

Using an S corporation may be the correct choice where the business qualifies for the IRC § 199A 20% business income deduction. In some cases, a business will not have sufficient W-2 wages to support the deduction after the owner hits the taxable income limits. In those instances, the owner may be able to become an employee of his or her S corporation and receive a salary that is included in the W-2 wage basis for IRC § 199A purposes. An owner

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cannot be an employee of his or her own sole proprietorship.

Two other possible benefits of operating the business through an S corporation include the potential to engage in some employment tax planning (the owner takes a reasonable salary and takes the rest of the profits as a shareholder distribution not subject to employment taxes) and the ability to take various expense deductions as top-line expenses in reaching the S corporation's taxable income.

6. Choice of entity planning tips for single owner businesses.

Never operate a business through an unincorporated sole proprietorship unless the business is uniquely free from contractual and tort liabilities and obligations. While an LLC or corporation won't generally shield an individual from responsibility for his or her own acts and omissions (the most often example is a tort of one sort or another – the owner and manager of a company runs over a pedestrian while delivering a chest for Kentucky Furniture, LLC), the entity will often effectively shield the owner and management from contract claims against the entity, subject to withstanding a piercing the entity veil attack.

The best entity choice where there is one business owner is likely a single member LLC, unless a check-the-box election is made for the LLC to be taxed as a corporation is treated as a disregarded entity for tax purposes, with the tax items from the business usually rolling over onto the owner's Form 1040, Schedule C. The single-member LLC will work fine in most cases.

7. Choice of Entity Analysis – Crunching the Numbers

Key assumptions for this choice of entity planning exercise:

- In the first comparison, the business nets $100,000 in taxable income per year for five years. In the second comparison, the business breaks even over the five-year period.

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- The comparison assumes that corporate income is taxed at a 21% rate, individuals are taxed at a 37% rate, and long-term capital gains are taxed at a 20% rate. The comparison ignores the sometimes significant impact of state and local taxes, employment taxes and the 3.8% net investment income tax (don't do this in a real-world planning situation). For the pass-through entity examples, the comparison assumes is that there would be an annual tax distribution to cover the owners' individual-level income taxes triggered by taxable income passing through on their Schedule K-1s.
- The comparison assumes that (i) the business issues equity (either C corporation stock or LLC interests treated as partnership interests) in exchange for the contribution of $20,000 from each of five investors, (ii) the business is operated for five years after formation, and (iii) the equity of the business or the assets of the business are then sold for $1,000,000. References to the "net" amount in the pockets of investors refer to the sales proceeds net of taxes and doesn't take into account the amount that they initially invested in the business (an aggregate of $100,000 in this example).

Obviously, some start-ups are sold before the fifth anniversary and many aren't sold for many years thereafter, and some aren't sold but instead go public, go bankrupt or are passed on to new ownership groups through arrangements that don't fit within the neat assumptions underpinning these comparisons.

The results of operating in a C corporation versus a pass-through entity where the business is held rather than sold may dramatically change the choice of entity analysis as the benefits of IRC § 1202 are only available when stock or assets are sold. The C corporation structure can be problematic to work with if the company is held instead of sold and there is pressure to distribute profits out to owners – this is difficult to accomplish in a tax-efficient way.

Pass-through entities are much more efficient vehicles for distributing earnings subject only to a single level of tax (although that tax rate will exceed the corporation's 21% rate).

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- The comparison assumes (perhaps incorrectly in the real world) that there will be no reduction in the purchase price offered for C corporation stock, even though the buyer won't receive the benefit of an inside tax basis step-up. The reality is probably that many buyers will discount the price if it won't obtain the full benefit of writing off the purchase price over time.
- The comparison assumes that all of the LLC's assets qualify will qualify for capital gains treatment. In the real world, it's likely that some portion of the consideration will be taxed at ordinary income rates because of the "hot assets" rules under IRC § 751 (ordinary income treatment for depreciation recapture, the sale of cash basis receivables, etc.).
- In order to simplify the comparison, there are numerous tax factors that are not taken into account that could move the dial in a real-world choice of entity analysis. For example, here are some factors that might favor use of a C corporation: (i) the $10,000 cap on itemized deduction of state and local taxes; C corporations do not have a similar limitation on its ability to deduct state and local taxes, (ii) owners of a pass-through entity are often required to file returns in multiple states where the company does business is another factor favoring C corporations, and (iii) the 3.8% net investment income tax and some state income taxes don't apply where IRC § 1202 (QSBS) treatment is applicable.

Other factors might be seen to favor the pass-through entity: (i) losses can pass through and be used at the individual level subject to certain limitations, (ii) lack of flexibility in structuring allocation of income and waterfalls, and (iii) limitations on tax-free contributions and distributions of appreciated property.

Results of First Comparison Where the Business Has Annual Net Income of $100,000 for the Five Years of Operation

The business owners decide to operate as a C corporation. For each of the five years of operation, the C corporation pays $21,000 in taxes (21% of $100,000).

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$1,000,000 NET. IRC § 1202 APPLIES AND STOCK IS SOLD. Assuming IRC § 1202 (QSBS) treatment is available to stockholders and the C corporation's stock is sold, the stockholders would have no taxes under IRC § 1202 in connection with the sale of their stock for $1,000,000. The stockholders would net **$1,000,000**. This is the result of fitting within the **C Corp Business Model** discussed above in the body of the article.

$893,950 NET. IRC § 1202 APPLIES AND ASSETS ARE SOLD. Assuming IRC § 1202 (QSBS) treatment is available to stockholders and the C corporation's assets are sold, after five years, the C corporation's basis in its assets is $495,000 (the initial $100,000, plus $79,000 per year – $100,000 net income minus $21,000 in federal tax). The corporation would have $505,000 of gain on sale of assets for $1,000,000 and pay $106,050 in taxes at the 21% corporate rate. There would be $893,950 left after payment of taxes for distribution to stockholders. Liquidating distributions to stockholders would be shielded from taxes under IRC § 1202, so the net amount in the stockholders' pockets would be **$893,950**.

$820,000 NET. NO IRC § 1202 AND C CORPORATION STOCK IS SOLD. Assuming IRC § 1202 (QSBS) treatment isn't available to stockholders and the C corporation's stock is sold: Investors have a $100,000 basis in the stock. A gain of $900,000 on the sale is taxed at the 20% capital gains rate ($180,000) for a net amount in the stockholders' pockets of **$820,000**.

$735,160 NET. NO IRC § 1202 AND C CORPORATION ASSETS ARE SOLD. Assuming it turns out that no IRS § 1202 (QSBS) treatment is available to stockholders and the C corporation's assets are sold, after five years, the C corporation's basis in its assets would be $495,000. The corporation would have $505,000 of gain on sale of assets for $1,000,000 and pay $106,050 in taxes at the 21% corporate rate. There would be $893,950 left after payment of taxes for distribution to stockholders. The stockholders would have $793,950 in capital gains ($893,950 – $100,000) taxed at 20% ($158,790) for a net amount in the stockholders' pockets of **$735,160**.

The business owners decide to operate the business as a pass-through (LLC taxed as a partnership).

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$883,000 NET. LLC ASSETS ARE SOLD. Assuming the business is operated as pass-through (LLC taxed as a partnership) and its assets are sold, the LLC members would pay aggregate taxes of $37,000 tax on the LLC's $100,000 annual income and the LLC would make an aggregate $37,000 tax distribution. The LLC's starting tax basis of $100,000 in its assets would increase each year by $63,000 and after five years, the LLC's tax basis in its assets would be $415,000. When the assets are sold for $1,000,000, there would be $585,000 of gain passing through to the LLC's owners to be taxed at the 20% capital gains rate. The LLC's owners would pay $117,000 (20% of $585,000) on this gain. So, the $1,000,000 in assets sales proceeds distributed to the LLC owners in liquidation would be reduced by $117,000 for a net amount in the LLC members' pockets of **$883,000**.

$883,000 NET. LLC INTERESTS ARE SOLD. Assuming the business is operated as pass-through (LLC taxed as a partnership) and the members sell their LLC interests, the members would have a $415,000 tax basis in their LLC interests after five years. After selling their LLC interests for $1,000,000, they would have $585,000 of gain taxed at the 20% capital gains rate. The $1,000,000 in sales proceeds is reduced by $117,000 (20% of $585,000) for a net amount in the LLC members' pockets of **$883,000**.

Results of First Comparison Where the Business Has Annual Net Income of Zero for the First Five Years of Operation

$1,000,000 NET. IRC § 1202 APPLIES AND STOCK IS SOLD. Assuming IRC § 1202 (QSBS) treatment is available to stockholders and the C corporation's stock is sold, the stockholders would have no taxes under IRC § 1202 in connection with the sale of their stock for $1,000,000. The stockholders would net **$1,000,000**. This is the result of fitting within the **C Corp Business Model** discussed above.

$811,000 NET. IRC § 1202 APPLIES AND ASSETS ARE SOLD. Assuming IRC § 1202 (QSBS) treatment is available to stockholders and the C corporation's assets are sold, after five years, the C corporation's basis in its assets is $100,000 (the initial $100,000). The corporation would have $900,000 of gain on sale of assets for $1,000,000 and pay $189,000 in taxes at the 21% corporate rate.

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There would be $811,000 left after payment of taxes for distribution to stockholders. The stockholders' distribution would be shielded from taxes under IRC § 1202, so the net amount in the stockholders' pockets would be **$811,000**.

$820,000 NET. NO IRC § 1202 AND C CORPORATION STOCK IS SOLD. Assuming IRC § 1202 (QSBS) treatment isn't available to stockholders and the C corporation's stock is sold, investors have a $100,000 basis in the stock. A gain of $900,000 on the sale is taxed at the 20% capital gains rate ($180,000) for a net amount in the stockholders' pockets of **$820,000**.

$669,000 NET. NO IRC § 1202 AND C CORPORATION ASSETS ARE SOLD. Assuming it turns out that no IRS § 1202 (QSBS) treatment is available to stockholders and the C corporation's assets are sold, after five years, the C corporation's basis in its assets would be $100,000. The corporation would have $900,000 of gain on sale of assets for $1,000,000 and pay $189,000 in taxes at the 21% corporate rate. There would be $811,000 left after payment of taxes for distribution to stockholders. The stockholders would have $711,000 in capital gains ($811,000 – $100,000) taxed at 20% ($142,200) for a net amount in the stockholders' pockets of **$669,000.**

The business owners decide to operate the business as a pass-through (LLC taxed as a partnership).

$820,000 NET, LLC ASSETS ARE SOLD. Assuming the business is operated as pass-through (LLC taxed as a partnership) and its assets are sold, the LLC members would net out zero taxes for the first five years of operation and the inside and outside basis for the LLC interests and assets would remain at $100,000. When the assets are sold for $1,000,000, there would be $900,000 of gain passing through to the LLC's owners to be taxed at the 20% capital gains rate. The LLC's owners would pay $180,000 (20% of $900,000) on this gain. So, the $1,000,000 in assets sales proceeds distributed to the LLC owners in liquidation would be reduced by $180,000 for a net amount in the LLC members' pockets of **$820,000**.

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$820,000 NET. LLC INTERESTS ARE SOLD. Assuming the business is operated as pass-through (LLC taxed as a partnership) and the members sell their LLC interests, the members would have a $100,000 tax basis in their LLC interests after five years. After selling their LLC interests for $1,000,000, they would have $900,000 of gain taxed at the 20% capital gains rate. The $1,000,000 in sales proceeds is reduced by $180,000 (20% of $900,000) for a net amount in the LLC members' pockets of **$820,000**.

Key takeaways from the comparisons:

If you can bring yourself within the **C Corp Business Model** and, in fact, are able to take full advantage of IRC § 1202, do it if you are willing to accept that the after-tax results of operating a C corporation that fails to qualify for IRC § 1202 treatment are substantial when compared to the results of operating the business through a pass-through entity. Obviously, there are risks associated with relying on a business plan that calls for operating the business for five years, qualifying for IRC § 1202 treatment, and finding a buyer who will pay full value for the company's stock.

Other than where the **C Corp Business Model** is achieved, the pass-through entity provides the best tax results. The results of operating through a C corporation that doesn't qualify for the benefits of the **C Corp Business Model** are either only comparable to those of the pass-through entity or, where Section 1202 doesn't apply, substantially underachieve the results of operating through the pass-through entity.

Operating as a C corporation where the stock doesn't qualify under IRC § 1202 and the buyer insists on purchasing assets opens the door for a very poor after-tax result that should be avoided.

Let's be clear that what is missing from these comparisons is actually what often happens in real life planning. The owners' plans change over time and the business isn't actually sold after five years. Instead, the business is sold after three years or after 10 years, or perhaps the business isn't sold and other succession planning options are employed. In most cases, the efficiency of

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using a pass-through entity to distribute income that is taxed at only one level will achieve superior results to operating as a C corporation and those results don't have the same degree of planning risk associated with chasing the **C Corp Business Model**.

More resources

In spite of the potential for significant tax savings, many experienced tax advisors are not familiar with Sections 1202 and 1045 planning. Venture capitalists, founders and investors who want to learn more about Sections 1202 and 1045 and related planning opportunities are directed to several articles on the Frost Brown Todd website:

- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Advanced Section 1045 Planning
- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202
- View all QSBS Resources

Contact Scott Dolson if you want to discuss QSBS issues by telephone or video conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[ii] IRC § 163(j), a provision added by the 2017 Tax Act, which creates a new limitation on the deductibility of net business interest expense that exceeds 30% of a taxpayer's "adjusted taxable

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income", applies at the corporate level if the buyer is a corporation and at the LLC level, if the buyer is an LLC. As a result, IRC § 163(j) should have a neutral impact on the choice of entity decision for a leveraged buy-out.

[iii] The $50 million gross asset value limitation will disqualify many target businesses from Section 1202's benefits.

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