The first step when forming a business is to decide what type of entity is the best form for the business. The best entity form for the business depends on structure, liability, management, and tax considerations. Non-tax factors usually are the primary considerations for choosing an entity because in many instances the equity owners can choose how the entity is treated for tax purposes.

Businesses are generally formed under state law as corporations, partnerships (including general partnerships, limited partnerships, limited liability partnerships, or limited liability limited partnerships), or limited liability companies.

For tax purposes, a business entity can be treated as a disregarded entity, C Corporation, S Corporation, or partnership. The tax classification of a business entity is important because the tax rules that apply to a disregarded entity, C Corporation, S Corporation, and partnerships are quite different.

The state law classification of a business entity is not always the same as the tax classification of a business entity. For example, a state law partnership can often elect partnership or corporation tax status.

Disregarded Entity Overview
- A business entity that is treated as a disregarded entity for tax purposes is an entity with a single owner that is generally ignored for tax purposes even though it is a separate legal entity for state law purposes. The owner of the disregarded entity is considered to own the assets (and is subject to the liabilities) of the disregarded entity for tax purposes and reports the entity’s income and expenses on its own income tax return.
- A single-member LLC that is treated as a disregarded entity for tax purposes does not file a United States federal income tax return. The sole member of the LLC reports the LLC’s income and expenses directly on its own income tax return.

C Corporation Overview
- All corporations other than S Corporations are C Corporations. To form a corporation, there must be one or more stockholders. Unlike the S Corporation ownership requirements, there are no restrictions on the types of owners in a C Corporation.
- The form of equity for a C Corporation is capital stock held by one or more stockholders. The two basic types of capital stock are common stock and preferred stock. A C Corporation may have multiple classes and series of stock with different rights and preferences.
- Distributions – Any distributions must be proportionate to stock ownership within each class of stock. However, preferential distributions are permitted for one class over another.
- Liability – A stockholder’s liability is limited to amount of capital contributed.
- Management – A C Corporation is governed by a board of directors. The board of directors must designate officers to manage the day-to-day operations. However, certain major decisions need to be approved by the stockholders.
- Capital Raising – A C Corporation raises capital through the issuance of stock and the incurrence of debt.
Stock can be issued by private placements or, if the C Corporation is public, by a public offering with stock that is registered with the Securities and Exchange Commission and listed on a public stock exchange.

- There is a lot of flexibility in the type of stock (common, preferred, convertible debt, phantom) that can be issued, but the C Corporation is limited by the number of shares authorized in its articles of incorporation. The number of shares authorized can be increased by amending the articles of incorporation which requires stockholder approval.

- A C Corporation may be restricted from diluting its current stockholders by the terms of a stockholders’ agreement. If the corporation has current holders of preferred stock, they may also have anti-dilution protection.

C Corporations generally are subject to two levels of tax on their income (at the entity level when earned and at the stockholder level when distributed). The relative inefficiency of two levels of taxation is somewhat reduced by the 21% corporate income tax rate that applies beginning in 2018. The top individual income tax rate is 37%. Even with the § 199A deduction, the income tax rate is likely to be more than 30% for individuals with pass-through business income.

- C Corporations are the most common corporate form for a public company. LLCs and limited partnership are typically converted to C Corporations before an initial public offering. An S Corporation must be converted to a C Corporation before an initial public offering.

- A C Corporation participate in tax-free reorganizations under § 368 of the Internal Revenue Code.

- C Corporations are not eligible for § 199A deduction.

- Shareholder cannot use losses incurred by corporation to offset other income. Corporate losses are reflected on the corporation’s return and are not passed through to shareholders.

- Shareholder can only take a loss on an equity investment (corporate stock) when the equity becomes worthless.
  - Capital losses generally may only offset capital gain; shareholder may deduct $1,500 ($3,000 if married filing jointly) per year against ordinary income.
  - Non-corporate shareholder may be able to take an ordinary loss for up to $50,000 ($100,000 if married filing jointly).

- If shareholder loans money to corporation, the shareholder may be able take a loss in the year the loan becomes worthless. This bad debt deduction will generally be capital loss.

- Florida Tax Trap! Remember, while Florida does not have an individual state income tax, the standard corporate tax in Florida on federal taxable income is 5.5%. While exemptions often lower a corporation’s effective tax rate significantly, a corporation is required to pay the higher amount of the standard rate minus all exemptions and credits, or an alternative minimum tax rate of 3.3%.

### Avoiding Double Taxation

#### C Corporation Makes S Election

- An eligible C Corporation generally can avoid double taxation by electing on formation to be treated as an S Corporation if it meets the requirements to make an S Corporation election.

- If a C Corporation makes an S Corporation election after formation, there are potential adverse tax consequences.
  - There are limitations on eligible shareholders of an S Corporation.
The converted S Corporation pays an entity level tax, at the corporate rate (21%), on any built-in gains (asset appreciation attributable to C Corporation years) if they are recognized during a specified recognition period after the S Corporation election takes effect (the “BIG Tax”).

- The specified recognition period was permanently reduced to five years for taxable years beginning in 2011.
- Asset appreciation occurring after the S Corporation election is not subject to the BIG Tax.

- If there is a chance of an acquisition in this recognition period, a C Corporation may not want to convert to an S Corporation because the S Corporation may have to pay a BIG tax if it is acquired by an asset purchase (or by a stock purchase treated as an asset purchase for tax purposes) during the recognition period.

Section 1202 Company

- A § 1202 company is one variety of C Corporation that can be structured to avoid taxes on accumulated earnings when its owners sell their ownership to a third party.
- Section 1202 currently provides for an exclusion of 100% of the gain from the sale of § 1202 stock (50% for stock issuances prior to February 18, 2009, and 75% for stock issuances between February 18, 2009 and September 27, 2010). The amount of excluded gain cannot exceed the greater of $10 million or ten times the taxpayer’s § 1202 basis in the stock (as determined on the date of the issuance of stock and which includes the fair market value of contributed property).
- To qualify as a § 1202 company, the following requirements must be met:
  - The stock must be C Corporation stock acquired after August 10, 1993;
  - The stock must have been acquired at the stock’s original issue (directly or through an underwriter) in exchange for money or other property or as compensation for services performed for the corporation;
  - The corporation must be a “qualified small business” immediately before and immediately after the issuance of stock:
    - A “qualified small business” includes any domestic corporation which is a C Corporation if the aggregate gross assets of such corporation at all times on or after the enactment of the Revenue Reconciliation Act of 1993 and before the issuance did not exceed $50,000,000, and the aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) do not exceed $50,000,000.
    - A trade or business eligible to be treated as a § 1202 company does not include any specified service trade or business under § 199A or any business in the fields of engineering, architecture, oil and gas, hotels, motels, and restaurants.
  - The qualifying stock must be held for more than five years; and
  - During substantially all of the taxpayer’s holding period of the stock, the corporation must meet the active trade or business requirements of § 1202(e).
    - The corporation cannot own real estate that is worth more than 10% of total assets (other than real estate used in the conduct of the business), and cannot own stock or securities with a value of more than 10% of the corporation’s total assets in excess of its liabilities (except there is no prohibition in the case of stock of a more than 50%-owned subsidiary, in which case the parent is deemed
to own its ratable share of the subsidiary’s assets and is deemed to conduct a ratable share of the subsidiary’s activities).

- § 1202 Stock Basis – If an LLC or partnership converts to a C Corporation in order to be treated as a § 1202 company, § 1202(i)(1) provides that the § 1202 basis of the issued stock is the fair market value of the contributed equity (i.e., the unrealized gain contained in the stock as of the date of contribution is not eligible for the § 1202 exclusion), which is a downside of waiting to convert from LLC status to C Corporation status (which may be offset by an extra § 1202 gain exclusion by reason of the ten times multiple now applying to the increased basis for the § 1202 stock). As an alternative, a partnership could contribute its assets to a newly formed C Corporation in exchange for stock and pass out the § 1202 benefits to eligible partners on the disposition of stock.

C Corporation Risks

- Moving to a C Corporation format to take advantage of lower rate involves tax risk.
- A C Corporation with retained accumulated taxable income has the risk that IRS will seek to apply § 531 to impose 20% tax on excess accumulated earnings.
  - Case law looks at whether taxable income was accumulated for reasonable needs of business or whether done to avoid recognition of taxable income by shareholders.
  - Corporations receive accumulated earnings credit of $250,000 ($150,000 for service business) less amount accumulated at end of prior year.
  - Treasury officials indicated they will look at issue more closely in light of lower corporate rate.
- A personal holding company is a C Corporation in which five or fewer individuals own stock and receive 60% or more of adjusted gross income (“AGI”) from passive sources, including rent, royalty, interest, dividend, and annuities. AGI is calculated by excluding capital gain, § 1231(b) gain, and certain other adjustments. There may be a 20% tax on undistributed personal holding company income. If a C Corporation makes the S election and has earnings and profits, S Corporation can be subject to personal holding company rules.
- Section 269 allows the IRS to disallow certain deductions or credits of a corporation if the principal purpose of the acquisition of the corporation was to avoid tax. Section 269 could be applied in certain situations in which an existing business moves a portion of its business into a C Corporation in order to avoid limits that would deny a §199A deduction.
- Section 482 allows IRS to reallocate income, deductions, and credits between two or more organizations under common control.

Who May Benefit From Forming a C Corporation?

- A business that operates in multiple states in order to avoid individual owners filing returns in various states.
- A business that is growing rapidly and prefers to self-finance growth.

S Corporation Overview

- An S Corporation is a “pass-through” entity for tax purposes, which means it does not pay an entity level tax. An S Corporation’s profits and losses generally pass-through to its stockholders who include their respective share of those items on their income tax returns (whether or not distributed). Any distributions to the stockholders must be proportionate to stock ownership. A stockholder’s liability is limited to amount of capital contributed.
• S Corporations have numerous ownership limitations which make it less popular than C Corporations. The limitations include the following:
  o There cannot be more than 100 stockholders.
  o With certain limited exceptions, only United States individuals (citizens or residents) can be stockholders. However, certain trusts and exempt organizations can also be stockholders.
  o Only an eligible United States entity can make the S Corporation election by timely filing the S Election on the IRS Form 2553.
  o An S Corporation can have only one class of common stock, but there can be differences in voting rights among shares of common stock. An S Corporation cannot issue preferred stock. Certain debt instruments as well as certain options, warrants, or similar instruments may be treated as a second class of stock under the S Corporation rules.
• Management – An S Corporation is governed by a board of directors. The board of directors must designate officers to manage the day-to-day operations. However, certain major decisions need to be approved by the stockholders.
• An S Corporation automatically converts to a C Corporation if it does not meet the requirements of an S Corporation.
• Capital Raising Considerations – S Corporations raise capital through the issuance of stock and the incurrence of debt. An S Corporation must be converted to a C Corporation before an initial public offering.
• Pass-through income from an S Corporation is eligible for the § 199A deduction.
• Shareholder may deduct proportionate share of losses incurred by S Corporation subject to passive loss and basis limitations. Shareholder must make the active or passive determination of character of losses.
  o If passive activity for shareholder, then losses can only be used to offset other passive income or are suspended and carried forward.
  o Losses may be deducted up to the shareholder’s basis in the stock. The shareholder’s tax basis includes the equity investment and loans by shareholder to corporation.
    ▪ However, a loan incurred by corporation cannot be used to increase shareholder’s basis for purpose of deducting losses.
• If there is a transfer of S Corporation stock, there are certain rules for allocating S Corporation income among the shareholders in the year of transfer:
  o If the shareholder is transferring less than its entire interest, then the S Corporation must use the pro-rata method where income for the entire year is ratably apportioned by days of ownership.
  o If the shareholder is transferring its entire interest, then the S Corporation will use the pro-rata method unless the S Corporation and all shareholders elect to close the books as of date of transfer.
    ▪ The risk to departing shareholder is the possibility of the allocation of substantial gain post-redemption.
  o When drafting governing documents for an S Corporation, consider negotiating for mandate of closing of books or contingent redemption price to cover additional tax liability.
• It is easier for an S Corporation to convert to a C Corporation than it is for an LLC or limited partnership to convert to a C Corporation because an S Corporation automatically converts to
a C Corporation if it does not meet the requirements of an S Corporation.

Conversion from S Corporation to C Corporation

- Given the new 21% flat tax applicable to C Corporations, some S Corporation shareholders might consider terminating the S Election and converting the entity to a C Corporation. One consequence of making the conversion might be a change in the accounting method. The former S Corporation may have used the cash method if it maintained no inventory, but the new C Corporation may be forced to use the accrual method.
  - Section 481 normally requires an adjustment in the year of change to prevent over- or under-inclusion. To mitigate the impact of the § 481 adjustment, the newly created § 481(d) prorates the adjustment over the first six taxable years starting with the year of conversion, but only in cases where: (1) the entity was an S Corporation on December 21, 2017; (2) the entity revoked its S Corporation status on or after December 22, 2017, and on or before December 21, 2019; and (3) all of the persons who were shareholders of the corporation on December 22, 2017 are the only persons who were shareholders of the corporation on the date of the revocation of the S Election.

- There are two possible ways that an S Corporation could consider a conversion to C Corporation status with the objective of making its shareholders eligible for the § 1202 exclusion.
  - The S corporation could revoke its S Election and become a C Corporation.
    - This rarely will be a desired strategy because of the § 1202(c)(2)(A) requirement that “during substantially all of the taxpayer’s holding period for such stock, such corporation . . . is a C Corporation.” In most circumstances, this rule would preclude the stock held by the existing shareholders as of the conversion date from qualifying as § 1202 stock; however, the rule would not apply to new infusions of cash or property into the corporation in connection with or following its conversion to C status in exchange for newly issued stock.
    - S corporation shareholders cannot contribute their S corporation stock to a C Corporation in exchange for § 1202 stock because § 1202(c)(1)(B)(i) requires that § 1202 stock be issued “in exchange for money or other property (not including stock).”
  - The S corporation could contribute its assets to a newly formed C Corporation in exchange for stock, which would qualify as § 1202 stock in the hands of the S corporation, if the C Corporation otherwise meets the § 1202 requirements.
    - On the disposition of the § 1202 stock, the S corporation would then pass out the § 1202 benefits to each of the S corporation’s shareholders who were such as of the date the assets/infusion occurred (but in no greater percentage than the shareholder’s percentage ownership on that date).

Partnership Overview

- Like an S Corporation, a business entity taxed as a partnership is a pass-through entity for tax purposes, which means it does not pay an entity level tax. A partnership’s profits and losses are computed and allocated among the partners annually and pass-through to the partners who include their respective share of those items on their income tax returns (whether or not distributed).
- A partnership must have two or more partners. Unlike an S Corporation, a partnership does
not have any other restrictions on the number, type, or residency of its owners.

- **Unlike S corporations, a partnership can have multiple classes of stock.** The economic rights can be divorced from the voting rights.

- **If a partnership is a limited partnership, there are two classes of partner: a general partner (who is generally responsible for management) and a limited partner.** A general partner has unlimited liability. A limited partner’s liability is limited to amount of capital contributed.

- **Management** – If the partnership is a limited partnership, management is initially vested in the general partner. The general partner may delegate management and may (but do not need to) designate officers to manage day-to-day operations. Certain major decisions typically have to be approved by the limited partners. The powers of the general partner can be limited by the limited partners in the limited partnership agreement. If limited partners participate in management, they risk losing the benefit of limited liability.

- **Capital Raising Considerations** – Limited partnerships raise capital through the issuance of partnership interests and the incurrence of debt. Partnership interests are typically issued in private placements. Limited partnerships are not limited by a preset number of authorized interests, but may be restricted from diluting its current partners by provisions in the limited partnership agreement. Because limited partners are prohibited from managing the partnership, it is a good vehicle when raising capital with silent investors.

- **Pass-through income from a partnership is eligible for the § 199A deduction.**

- **A partner can use allocable share of partnership debt to increase own basis in partnership interest for purposes of deducting partnership losses.** This is in contrast with the S Corporation rules that do not allow debt to increase stock basis.

- **Losses are subject to passive loss and basis limitations (same as with S Corporations).**

- **A partnership cannot participate in a tax-free reorganization under § 368.**

**Differences between Partnerships and S Corporations**

- **Although both S Corporations and partnerships are pass-through entities for tax purposes, the tax rules that apply to S Corporations and partnerships are somewhat different.**
  - An S Corporation must divide profits according to share ownership. By contrast, a business entity that is a partnership for tax purposes generally can divide profits in any way it chooses. Thus, distributions in a partnership do not need to be proportionate to partnership ownership.
  - All trade or business income of a partnership generally is considered self-employment income to the partners and is subject to self-employment tax. For S Corporations, generally only the compensation income paid to the stockholder-employee is subject to employment tax. Any other income is not subject to employment tax. This often results in substantial employment tax savings for the owners of an S Corporation.
  - Partnerships do not qualify for certain statutory benefits available only to C and S Corporations. For example, a partnership cannot issue incentive stock options. However, a partnership can often use a profits interest (share of future profits and appreciation, but none of the existing value of the partnership) to achieve the same or better tax result (than an incentive stock option) for its holders.

**Conversion of Corporation to Tax Partnership**

- There are many options to implement a conversion of a corporation into a partnership:
  - File a state law conversion/merger;
- Check-the-box election;
- Corporate liquidation and distribution of assets to shareholders followed by formation of tax partnership;
- Corporate drop-down of assets followed by distribution of tax partnership interests in liquidation.

- A corporation recognizes gain on deemed sale of assets equal to difference between fair market value of assets less tax basis of assets. Any C Corporation gain is taxed at 21%. S Corporation gain flows through to shareholders, increasing the shareholders’ stock basis, but the shareholders may have ordinary income because of depreciation recapture.
- Shareholders recognize gain on value on actual or deemed distribution of interests in tax partnership less tax basis in stock of corporation.

**Conversion of Tax Partnership to Corporation**

- There are many options to implement a conversion of a partnership into a corporation:
  - File a state law conversion/merger;
  - Distribution of assets to shareholders followed by formation of tax partnership;
  - Partnership drop-down of assets followed by liquidation of tax partnership
- If debt exceeds tax basis of assets, there may be potential recognition of gain under § 357(c).

**Limited Liability Company Overview**

- An LLC must have two or more members if the LLC wants to be taxed as a partnership. An LLC does not have any other restrictions on the number, type, or residency of its owners.
- The form of equity for an LLC is percentage of membership interests held by one or more members. It is permissible to classify membership interests into different classes (like common and preferred stock) with different rights and preferences. Distributions do not need to be proportionate to LLC ownership. Distribution, liquidation, and voting preferences can be specified in the limited liability company agreement. A member’s liability is limited to amount of capital contributed.
- Even though an LLC is a recognized type of business entity formed under state corporate law, LLCs do not have their own United States federal income tax regime. For tax purposes, an LLC can be classified as a disregarded entity, C Corporation, S Corporation, or a partnership. A single-member LLC is treated as a disregarded entity and a multi-member LLC is treated as a partnership for tax purposes unless the LLC elects C or S Corporation tax status.
  - An LLC treated as a partnership will be a pass-through entity for tax purposes, which means it does not pay an entity level tax. In such an instance, the LLC’s profits and losses are computed and allocated among the partners annually and pass-through to the partners who include their respective share of those items on their income tax returns (whether or not distributed).
- Management – Management is initially vested in the members. Members can delegate management to a managing member, non-member manager, or board of managers. The manager(s) can (but do not need to) designate officers to manage day-to-day operations. Certain major decisions typically have to be approved by the members. The management structure is flexible and is primarily determined by the members and set out in the limited liability company agreement.
- Capital Raising Considerations – LLCs raise capital through the issuance of equity (membership interests) and the incurrence of debt. Membership interests are typically issued
in private placements. Members can create membership interests that mirror the properties of different types of stock. LLCs are not limited by a preset number of authorized interests, but may be restricted from diluting its current members by provisions in the limited liability company agreement.

- An LLC cannot participate in a tax-free reorganization under § 368.

### Considerations in Structuring or Converting Entities

- **Expectation of income from operations**
  - If reinvest income in business, the lower corporate tax rate may be attractive.
  - If distribute income to owners, pass-through ownership is likely still preferable.

- **Expectation of losses from operations**
  - There is a flow through to owners of pass-through entities.
  - Losses are carried forward in a C Corporation.

- **Potential sale of business**
  - Forming a C Corporation allows for possibility of § 1202 benefit.
  - Forming a pass-through entity provides the ability to sell assets and generate majority capital gain.

- **Family business** – A partnership allows the partners to make a § 754 basis adjustment.

- **Where there is pressure to distribute a substantial portion of operating earnings by compensation and/or dividends, the LLC format often will be the preferred vehicle.** Even if there is no immediate pressure to distribute after-tax earnings, the earnings retained in C Corporation format need to be retained for a significant time period to overcome the double cost of C Corporation format (versus the 29.6% maximum federal rate on LLC earnings).
  - There are instances in which an entity can qualify as an LLC or a C Corporation that qualifies for § 1202 treatment.
    - A § 1202-qualifying business that has little in the way of operating profit and that is expected to be sold before a significant period of time elapses should be formed as a C Corporation because if the discount resulting from selling § 1202 stock turns out to be “too much”, the corporation can sell assets and avoid tax on liquidation under § 1202, without much of a difference vis-à-vis an LLC asset sale.
    - A business that is expected to be held multi-generationally generally takes § 1202 off the table, and entity choice often comes down to the magnitude of earnings that are expected to be retained for business use and for how long.
    - Where a flow-through owner is expected to have taxable income (including flow-through income) taxed at lower than the maximum marginal individual tax rate, at least for more than a de minimis portion of the expected life span of the business, this is a factor that favors the flow-through format.

- **There are other factors that should be part of the entity choice decision-making process.**
  - Where it is anticipated that significant funds need to be accumulated for business growth or expansion, that is one factor favoring C Corporation status with its 21% federal tax rate (subject to a consideration of the differential, if any, in state income tax rates between individuals and corporations). Accumulating funds in a C Corporation that are not needed for business purposes generally will not be of much utility because of the potential accumulated earnings “triple tax.”
  - Will the 20% § 199A deduction disappear after 2025? If § 199A disappears, will §
1202 status then be available to convert a partnership or S Corporation to C Corporation format and what are the factors in so waiting?

- In the case of a flow-through entity, losses are deductible by its owners, subject to the passive loss rules and the new excess business loss rules (and at-risk and basis limitations, with basis limitations being more relevant in the case of an S corporation), whereas losses in C Corporation format are available only to the C Corporation, subject further to the net operating loss rules. Even if a decision that C Corporation format is preferred for the long run, partnership format may be preferred during the period that losses are anticipated, such as during the start-up phase.

- The owners of the business need to consider the capital loss results if C Corporation stock is disposed of at a loss. Losses with respect to an investment in a business operated in a flow-through entity generally are ordinary in character (assuming the flow-through entity interest itself is not sold, or the loss is not generated by a § 1221 capital asset sold by the partnership).

- In the event of a dispute among the business owners, a partnership is easier to split up on a tax-free basis than a corporation, as the latter must navigate the stringent requirements of the corporate spin-off rules in § 355.

- In the event of transfers of an ownership interest, including transfers to third parties or on the death of the owner, the benefits of a basis step-up via a § 743(b) basis adjustment can be a major advantage vis-à-vis a transfer of stock.

- In a death situation, a redemption of a partnership interest is easier to accomplish than a redemption of C Corporation stock, the latter of which can result in a taxable dividend in the context of a family-owned business, if waiver of the family attribution rules is not an option.

- There is greater flexibility in providing tax-free ownership interests to key personnel in partnership format because tax-free profits interests can be issued (subject to the limited scope of the new § 1061 limitations), rather than in corporate format, where the receipt of corporate stock is taxable (subject to delayed taxation pursuant to the § 83 rules, if applicable). While a C Corporation may drop its operating business into an LLC for purposes of providing a service provider with a profits interest, there is a serious risk that the C Corporation stock will then fail to qualify as § 1202 stock, as the C Corporation may flunk the active business requirement.