



Tax Planning: Which Organization Structure is Best?

Cathedral's Topic of the Month is designed to create an orderly review of the various aspects of a business. This allows management to get ahead of the issues that should be considered and addressed. February is tax month, because corporations file their tax return in March and partnerships and individuals file in April. Rather than waiting until year end, taxation planning can be used as part of budgeting, early in the year and towards the end of year.

In this Topic of the Month, we will consider which organization structure is best?

The Legal Side

In the past there were three main alternatives for the organization of a business: 1. a sole proprietorship, 2. a partnership and 3. a corporation. Now we have added the limited liability company (LLC), making 4 different alternatives.

The key legal issues are limited liability. Only the corporation and the LLC provide protection for the owners from the business activities of the company. These are called limited liability entities because the owner only has risk for the capital that he has committed to the company. The corporation and LLC are entities chartered by a state. The entity is treated as separate from its owners, the shareholders for a corporation and its members for a LLC. The owners do not have liabilities for the activities of the corporation. Limited liability does require that the company is properly organized and operated. Too often the corporation and the LLC have not been fully setup and annual meetings maintained. Such failure puts the owner at risk, as if the corporation or LLC does not exist.

The partnership and sole proprietorship do not create liability protection. If the business is sued, then the assets and net worth of the owner are fully available to the creditors of the business. This is why business owners are encouraged to either incorporate or form an LLC. Many partnerships try to achieve limited liability protection by creating a limited partnership (LP). While LPs work for limited liability, they do have a number of tax issues. Today the LLC can achieve the same results as the LP, with much easier structuring and taxation.

The Tax Treatment

The Corporation

The corporation is a separate tax entity. For tax purposes, a corporation can have one of two statuses: 1. a C Corporation often referred to as a C corp., or 2. a S Corporation, often referred to as an S corp. or SubS corp. The "C" and the "S" refer to parts of the Internal Revenue Code (IRC) under which each is taxed. The C corp. is taxed under subsection C of the IRC and the S corp. is taxed under subsection S of the IRC.

A C corp. is treated as a separate taxpaying entity from its shareholders. As an entity, a C corp is responsible for the taxes on its earnings. The shareholders do not pay tax on the operating earnings until they are distributed in the form of dividends. The dividends from the C corp. are then taxed at special rates, currently 15%. The taxation of the same earnings at both the company level and the shareholder level is referred to as “double taxation.” So a C corp. is said to have double tax on its earnings. The tax return for the corporation is Form 1120. Often tax returns are used as names to describe the entity, so we will list them here.

A S corp. is treated as a pass-through entity. A pass-through entity does not pay tax on its earnings. Instead, the earnings are passed through to the owners, in this case the shareholders, and the shareholders report the earnings on their tax returns, as if they had earned the amount directly. As a result, the S corp has only one level of tax, at the shareholder level. Earnings can be withdrawn without further taxes at any time. Other pass-through entities are partnerships and limited liability companies (LLC). The S corp. tax return is Form 1120S

Both the C corp. and the S corp. have significant rules which are beyond the scope of this paper.

The LLC

The LLC starts as a partnership for tax purposes. But the LLC can choose to be either a partnership or a S corp. In either case the entity is treated as a tax pass through in that the income is taxed to the owners and not the entity. The partnership LLC tax form is Form 1065 and the S corp. LLC tax form is Form 1120S.

Let us explore the differences between these two. First, the pass through of losses is different between the two. Both entities make any tax losses available to the owner. The owner needs basis in the interest in order to use the tax losses to offset other income. Basis can be easiest described as the investment made in the company. But it can include loans to the company. For the S corp. the loans must be made directly by the shareholder, not just guaranteed by the shareholder. For the LLC, loans can include both those made directly and those guaranteed. Nonrecourse loans to the LLC create separate issues, not addressed here. The benefit of the LLC for businesses is significant, where there is equipment that is financed.

The character of the income of a partnership LLC and a S corp. LLC can be different. The partnership LLC income will generally be treated as earned income, subject to self employment tax. There is no limit to the amount of the income that is so treated for the partnership LLC. The S corp. LLC has two types of income, the compensation for the owner/employee and investment income. There are two dynamics for these characterizations. First, if the operations have tax losses, then the partnership LLC would not create any compensation to the owner/employee. Whereas the S corp. LLC may have losses, but the compensation income to the owner/employee would still be treated as compensation. Further the S corp. LLC losses could not be used to offset the compensation income of the owner/employee. This character difference creates a planning option where a business may start as a partnership LLC during the loss period, then switches to a S corp. LLC going forward. Needless-to-say, it is not as easy as it sounds, as with all tax planning.

When a LLC is owned by a single individual, the LLC is viewed for tax purposes as a non-existent entity. Therefore, the LLC owned by a corporation is viewed as a division of the corporation. The LLC owned by one individual is viewed as a sole proprietorship. The functional tax implications for these LLCs are to look at the owning entity for tax planning.

The Partnership

The partnership is taxed the same as the partnership LLC, above.

The Sole Proprietorship

The sole proprietorship for tax purposes is viewed as an extension of the individual. The business shows up on the individual's tax return, Form 1040, on Schedule C.

General Tax Planning

General tax planning for these different company structures does vary. Here we do not have space to discuss all of these in detail. Generally, the categories of deductions, treatment of benefits, and compensation related payments are areas for concern.

The Transaction Problem with the C Corp

The C corp. creates loss in value in a sale transaction, because of double taxation. The double taxation and loss of value arises as follows:

C corp. XYZ's shareholders decide to sell, and ABC corp. decides to buy. XYZ has machinery of value, but no tax basis for future depreciation. The price is \$100,000. XYZ shareholders want to sell their stock to get capital gain. However, if ABC buys the XYZ stock, ABC gets a basis of \$100,000 in the stock, but the machinery basis does not change. Therefore ABC gets no depreciation on the purchase price. So ABC wants to buy assets to get \$100,000 depreciable basis in the machinery, which would result in about \$35,000 in tax savings. At this point we can see that a stock sale is \$35,000 inefficient to ABC, so it would offer \$65,000 for the stock and \$100,000 for the assets. XYZ shareholders do not want to sell the assets because the tax would be \$35,000 at XYZ level and then a tax of about \$9750 on the distribution of the remaining \$65,000. At a minimum the loss in value to the seller, XYZ shareholders, is about 10%, but often it is closer to 35%. This assumes that the machinery would not qualify for capital gains treatment.

By contrast, if C corp. were a S corp. or LLC, the assets could be sold for only one tax of \$35,000. No further taxes would be required. Therefore, the double tax is avoided.

The problem then is the double tax on transactions of C corps which can be avoided if the entity is a S corp.

Sale of Asset	XYZ Shareholders Sell Asset				ABC Asset Purchase			
		Gain	Tax Rate	Tax		Basis	Tax Rate	Tax Savings
Value of Assets	\$ 100,000	35%	\$ 35,000	Depreciable Basis in Asset	\$ 100,000	35%	\$ 35,000	
Dividend to Shareholders	\$ 65,000	15%	\$ 9,750	Total Depreciable Basis:	\$ 35,000			
	Total Tax: \$ 44,750							
Sale of Stock	XYZ Shareholders Sell Stock				ABC Stock Purchase			
		Gain	Tax Rate	Tax		Basis	Tax Rate	Tax Savings
Value of Stock	\$ 100,000	15%	\$ 15,000	Depreciable Basis in Stock	\$ -	0%	\$ -	
	Total Tax: \$ 15,000			Total Depreciable Basis:	\$ -			
	Tax from Sale of Assets: \$ 44,750			Asset Purchase Total Tax Savings from Depreciable Basis:	\$ 35,000			
	Tax From Sale of Stock: \$ 15,000			Stock Purchase Total Tax Savings from Depreciable Basis:	\$ -			
	XYZ Shareholder Tax Difference (Stock Sale Tax Savings): \$ 29,750			ABC Tax Difference (Asset Sale Tax Savings):	\$ 35,000			
	XYZ Asset Desired Purchase Price	\$ 100,000		ABC Asset Offer Purchase Price	\$ 100,000			
	XYZ Stock Desired Purchase Price	\$ 100,000		ABC Stock Offer Purchase Price	\$ 65,000			

The Solution - Conversion to S Corp or LLC

The solution is to convert a C corp. to a S corp. A conversion can be done by the shareholders of the C corp. electing to be a S corp. The election must be filed by the 15th day of the third

month following the start of the tax year. For calendar year companies, this filing must occur by March 15th. All shareholders must agree to the S corp. election.

The details of a conversion to a S corp. or LLC are beyond the scope of this Topic of the Month. Further information on the analysis required can be found in our White Paper “C to S Tax Conversion”. Click [here](#) to read the Cathedral White Paper on this topic.

A conversion of a C corp. to a LLC has similar benefits to the S corp conversion, but is a change in legal structure, requiring a liquidation of the C corp. While there may be benefits in going this far, the analysis must include the liquidation implications.

Overall, business conversions are not to be taken lightly. Planning is crucial to ensure all legal and financial steps are taken properly. Changing the business structure of an entity can reap many financial benefits due to tax savings attached to such a formation or conversion. It is important to note that tax rates and regulations are continually changing. It is encourage that before making any change or conversion to a business entity, seeking assistance and/or aid in the process is a recommended step from the beginning.

Articles for Further Reading:

1. IRS. “Business Structures”.
<http://www.irs.gov/businesses/small/article/0,,id=98359,00.html>
2. Hupalo, Peter. “Choosing a Business Structure.” <http://www.thinkinglike.com/Small-Business-Book/Business-Structure.html>
3. Dow Jones & Company, Inc. “Structure Your Business with Tax Breaks in Mind”. 2003.
<http://www.inc.com/articles/2003/11/structure.html>
4. Cathedral Consulting Group, LLC. “C to S Tax Conversion”. October 2011.
http://www.cathedralconsulting.com/files/TOPIC_C_to_S_Tax_Conversion.pdf

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