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By Robert W. Wood

IRS Tax Election Is Worth $10 Million Tax Free

Choosing what type of legal entity to use for a business may *sound* like a real yawn of a topic. You can pick between corporations, partnerships and limited liability companies (LLCs). Of course, you can also operate without a business entity at all, working as a sole proprietor. If you do that, you just report your income and deductions on Schedule C to your tax return. That is how many small businesses start.

Decades ago, when an individual outgrew a sole proprietorship, a corporation was almost always the logical choice. Incorporation brought limited liability and more formality. In more recent decades, LLCs became the new norm. They are taxed as partnerships, so LLC members pay the taxes. But LLCs too have limited liability. The flow-through tax treatment is favored, and the new 20% pass-through tax deduction made it more so.

But if you have a corporation—one that you formed or inherited—should it be an S or a C corporation? As we'll see, that can turn out to be a $10 million question. You might not even know what type of corporation you have. All corporations are C corporations, unless they file a simple election for S corporation status. C vs. S status is all about taxes. If you file an S election with the IRS, the corporation will be taxed almost like a partnership or LLC. And subject to various limits, you can change from one to the other, and back again.

You might think you would never want to have a C corporation. After all, income from a C corporation is taxed twice. The corporation pays tax on its net income. Then, shareholders also pay tax on dividend distributions they receive. In contrast, income from an S corporation is taxed once at the shareholder level. Starting in 2018, the tax law radically cut the corporate tax rate paid by C corporations from 35% to 21%. That means C corporation status is much better, right?

Not necessarily. Compare that 21% rate to how an S corporation is taxed. Individual tax rates were also cut. The top rate dropped from 39.6% to 37%. Then there's the pass-through deduction. If you qualify, it can reduce the top effective tax rate from 37% to 29.6%. For many, the idea of a 29.6% tax rate sounds pretty good, even compared to the 21% C corporation tax rate. So is S corporation treatment better?

It depends on your facts, and what could happen down the road. It can turn out to be a $10 million issue. Qualified Small Business Stock (QSBS) treatment only applies to C corporation stock, and it is an astounding benefit. For the small companies that qualify—generally up to $50 million in assets—shareholders who have held their stock for 5 years may be able to exclude up to $10 million of their gain from federal tax. If you sell QSBS but have not held it for 5 years, there is another QSBS benefit. You can defer the gain by rolling it over into a new investment in QSBS.

If you want to go for QSBS benefits, do not file an S election for the business, as it can cost you $10 million. The QSBS rules can allow founders and other shareholders big tax free or tax deferred benefits. How do you weigh the pluses and minuses of S vs. C on your facts? Run some numbers both ways, and get some professional advice. If you incur losses, you want to claim them personally if you can, so consider that possibility too. Consider operating income vs. sale proceeds. Consider the potentially huge QSBS benefit v. the risk of double tax that usually follows from C corporation status.

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