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# With $10M Tax Break Only For C Corporations, Should Your Business Elect S?

2021 seems likely to hold big tax changes, but how much higher will they go, and on what specifically? First, remember where we are in this wild ride. The massive tax law that took effect in 2018 radically reshaped many aspects of traditional tax planning. A prime example of the fundamental shift involves choice of entity for many small businesses. Corporations, partnerships and limited liability companies (LLCs) are still in the mix as the available choices, but many tax incentives changed. For generations, when an individual outgrew a proprietorship, a corporation was almost *always* the logical choice. In more recent decades, LLCs became the new normal. They are generally taxed as partnerships, so the partners (or using the terminology of LLCs, the ‘members’) pay taxes on the business income themselves. Flow-through tax treatment is still favored, but starting in 2018, now even more so with the complex but nifty pass-through deduction. But if you have or are forming a corporation should it be an S or a C?

Among the issues, consider Qualified Small Business Stock (QSBS) treatment, which only applies to C corporation stock. For the small companies that qualify—generally up to $50 million in assets and meeting certain other tests—shareholders who have held their stock for 5 years may be able to exclude their gain from federal tax. The shareholder limit is usually $10 million, and $10 million tax free would be nice! 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. All in all, the QSBS rules can allow founders and other shareholders huge tax free or tax deferred benefits.

Of course QSBS is only one issue. And besides, if you read the QSBS rules closely, you might conclude that your business is not eligible. That might sway you back toward S status. Articles of Incorporation do not say if the corporation is an S or a C. In fact, all corporations are C corporations (under subchapter "C" of the tax code) unless they file for S corporation status. If you take no action to elect S corporation tax treatment from the IRS, your corporation is a C corporation. An S election has nothing to do with limited liability. Whether you have an S or a C, a corporation is entitled to limited

liability. Limited liability is one traditional reason businesses incorporate (although LLCs are also entitled to limited liability). But C vs. S status is all about taxes. If you file a one page S election with the IRS, the corporation will be taxed almost like a partnership or LLC. Subject to limits, you can change your corporate states.

A corporation can be taxed as a C for many years, and then change to S status. However, there are limits on converting from S to C, and vice versa. If you change too soon or too frequently, you must ask the IRS for permission. In effect, the tax code imposes a kind of hybrid corporate tax on S corporations that convert from C status. However, by filing an S election upon the initial formation of the corporation (generally in the first 75 days after the corporation is formed), it will *never* be a C corporation. That way, the company and its shareholders do not need to worry about the built-in gain tax that can apply to conversions from C to S. So, you can avoid that complication if the corporation files S status from the beginning.

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. But starting in 2018, the corporate tax rate dropped from 35% to 21%. That means C corporation status is much better, right? Not necessarily. Yes, the corporate tax rate is lower, but individual tax rates were *also* cut. In 2018, the top rate dropped from 39.6% to 37%. What's more, owners of many pass-through businesses (including S corporations) can deduct 20% of their pass-through income. If you do the math, that reduces their top effective tax rate from 37% to 29.6%. There are qualifiers and limits, but a 29.6% tax rate sounds pretty good. 29.6% seems high compared to the 21% C corporation tax rate, but consider shareholder taxes as well.

Dividends are generally taxed at 15% or 20%, depending on income levels. Considering the corporate tax and the shareholder tax, unless you leave all income in the corporation, you end up paying more in taxes with a C corporation, even at the new low 21% corporate rate. An S corporation can have no more than 100 shareholders, only U.S. citizens and resident aliens as shareholders. The shareholders must generally be individuals (and certain limited types of trusts), and the corporation must generally have a calendar year. If there are multiple classes of stock, only differences in voting rights are allowed. And an S corporation can face corporate tax if it was previously a C corporation and elected S status within the last 5 years (the built-in gain tax).

How do you weigh the pluses and minuses on your facts? Usually, C corporations are not the best choice for small businesses. The main reason is the double tax on income and on the proceeds of sale. However, one huge benefit of C corporations is qualified small business stock treatment—which can bring up to $10 million tax free to shareholders, only for  corporations. On the other hand, if you incur losses, you want to claim them personally, which favors an S corporation, especially with the pass-through tax break. Whatever you do, get some advice, and pay attention to the tax rules. And stay tuned for post-election tax moves, whatever happens.

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