Financial, Legal & Tax Advisory

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Why choose a C-Corporation?

When starting or purchasing a business, the classification of the entity is very important. There are several different options to choose from, such as sole proprietors (where income is reported on an individual's schedule C) or partnerships (where income is reported on a business' Form 1065). However, other individuals may find it more beneficial to elect a corporation, specifically a C Corporation, to minimize tax burdens. What exactly is a C Corporation? A C Corporation is a business entity that is taxed separately from its owners under Subchapter C of Chapter 1 of the Internal Revenue Code. Many businesses organized under a Federal or State statute that refers to the entity as a corporation are automatically treated as a C Corporation for federal tax purposes.

A C Corporation is owned by its shareholders, and those shareholders elect a board of directors. This board of directors is responsible for the oversight of any corporate business and affairs. Corporate officers carry out the day-to-day management of the business, and in smaller corporations, those board members are often members of management. C corporations can be either publicly held or privately held entities. Public C Corporations sell shares to the public while privately held companies do not. When looking at filing taxes as a C Corporation, you will use Form 1120 to report business financial information such as income, gains, losses, credits, and deductions. With the corporation being recognized as a separate tax-paying entity, you have protection from the flow through an audit to personal returns.

Along with this, C Corporations face a lower minimum tax rate. The 2017 Tax Cuts and Jobs Acts permanently changed the tax structure for C corporations. Essentially, if you are a C corporation in the United States, you will pay a flat tax of 21%. You will not pay capital gains of 23.8% or extra taxes for the alternative minimum tax. Some of the tax deductions available under this tax law are also much greater than before. Within this act, the top individual tax rate dropped from 39.6% to 37%. Even with the additional 20% deduction for qualified business income that could lower this rate to 19.6%, many taxpayers may see benefits from changing their businesses into C corporations. 1202. Section 1202 allows founders and investors of corporations to exclude up to 100% of their capital gains.

Another great benefit of a C Corporation is a valuable section of the Internal Revenue Code known as Section derived from the sale of Qualified Small Business Stock (QSBS) held for more than five years. While there are some stringent requirements to qualify, this is just one of the many benefits of being a C Corporation. While most people understand the seller's side of a 1202 sale, it is important to understand buyer strategies when purchasing a C-Corporation. The acquisition of C Corporation stock from a secondary purchase (shareholder to shareholder) would not be QSBS when in the hands of the purchaser. However, the seller of that stock may be eligible for Sec. 1202 benefits if all the requirements are met. Buyers will be more likely to acquire the assets of a target through a NewCo instead of purchasing the stock directly from a seller.

When looking at an asset purchase, the purchaser will be able to receive a basic step-up for acquiring the target's assets. Along with this, if cash is contributed to a NewCo by the purchaser in exchange for originally issued stock and then the NewCo purchases the target assets, the NewCo stock the purchaser received may be QSBS if all the other requirements are met (held for 5 years, etc.). Sellers look to avoid any of the corporate-level tax imposed by an asset sale. This is why sellers usually insist upon a stock sale. The NewCo stock received by the purchaser could still be considered QSBS even if NewCo is being used as a holding company by the purchaser to acquire target stock.

The purchaser often has many reasons for using a holding company to purchase stock from the target. Holding companies are often preferred by investors in this scenario because they block any of the target's historical earnings and profits. No language in Sec. 1202 or other guidance from the IRS would prevent NewCo stock from being QSBS in this situation. Business owners must check immediately with their business broker, accountant, or legal counsel regarding their business structure. This is especially true for those who plan to sell within the next couple of years. If you are looking to start a small business or even purchase an existing company, do not hesitate to reach out to the professionals at The Center for Financial, Legal, and Tax Planning, Inc at our website, www.taxplanning.com or by phone at (618) 997-3436.

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