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How to Choose the Right Business Entity

By Ryan Woodhouse on May 16, 2016

Business-EntityWhen launching a new business venture, the type of business entity you choose depends on your business goals. If an initial public offering (IPO) is in your future, a C-corporation is the best choice. If the IPO is a far-reaching goal, you might want to consider an S-corporation election, especially if an outright sale becomes the exit of choice, vs. the IPO option. With the M&A market strengthening and private equity firms having available capital, this very well may be an option for growing businesses.

The difference among C corporations, S corporations and partnerships

For C corporations, income and losses are reported and taxed at the corporate level, and profit distributions are generally characterized as dividends. There's no deduction for profit distributions at the corporate level, because dividend income is allocated to the shareholder who recognizes the dividend at fair market value when reporting it for individual income tax purposes. Any noncash distributions trigger a gain at the corporate level.

As an S corporation, a business's income and losses are passed through to the shareholder level, and allocation is equal for all shares. Noncash distributions trigger a gain at the corporate level that is then passed through to the shareholders. However, this increases the shareholder's stock basis, which will eventually offset future income or generate a loss when the stock is sold.

As a partnership, a business's income may be allocated among the partners with various preferences, guarantees and tranches in order to reflect the agreed-upon economic sharing of the partners, as long as certain safe harbor provisions are met. In addition, noncash distributions do not generally trigger a gain.

Operating income treatment

C corporations are taxed on operating income at the corporate level, which can climb up to the maximum federal rate of 35 percent, and the lower capital gains tax rate does not apply for corporations. Capital losses are allowed up to the level of capital gains and can be carried forward five years or backward three years.

In S corporations and partnerships, all income is passed through and reported and taxed at the shareholder or partner level. Capital gains and losses are taxed at the shareholder's or partner's capital gain rates and subject only to the limitations at the shareholder or partner level.

Business loss treatment

If you think that business will be generating losses, at least for a while, it's important to consider how those losses will be treated for tax purposes. For C corporations, losses may only be carried over at the corporate level, while S corporations pass losses through to shareholders to the extent of stock basis, plus basis in shareholder loans to the corporation.

However, if the firm will be heavily leveraged, a partnership may be preferable. Partnerships can utilize losses in much the same way S corporations can. Losses pass through to the extent of basis in partnership interest (capital account plus allocable share of debt, including debt from banks and other third parties), with one caveat that at-risk limitations will limit losses funded by nonrecourse debt unless it is qualified.

How the three entity structures differ in tax implications upon exit

A sale or liquidation of the assets by a C corporation results in double taxation. The corporation realizes gain or loss from the sales of the assets, pays corporate income taxes and distributes the remaining assets to the shareholders, who will be taxed on the proceeds they receive.

The S corporations is regarded as a single-taxation entity when the business is sold, so gains and losses resulting from the sale are passed through to shareholders, who report the income and losses and pay the taxes. Stock basis is increased, thereby reducing gain on stock redemption.

In the event of a liquidation of a partnership by distribution of the assets to the partners, no gain or loss is generally recognized, so there's no tax.

In the event of a sale of the partnership's assets, gains and losses at the partnership level are passed through to the partners, who report the income and losses and pay the taxes. The partners' bases in their partnership interest receive a corresponding increase or decrease, thus ensuring only a single level of taxation.

About the Author: Ryan Woodhouse, a tax principal, brings to Haskell & White 10 years of experience providing corporate and partnership tax consulting and compliance services. Woodhouse serves a variety of clients, both public and private, from industries such as manufacturing, real estate, medical device and professional services. He earned a bachelor's degree in business administration with a concentration in accounting from the California State University, San Bernardino. He can be reached at rwoodhouse@hwcpa.com.