1987

Choice of Entity: C Corporation Versus Pass Through Entities

Gail Levin Richmond

Repository Citation
https://scholarship.law.wm.edu/tax/588

Copyright © 1987 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
https://scholarship.law.wm.edu/tax
CHOICE OF ENTITY: C CORPORATION VERSUS PASS THROUGH ENTITIES

By

Gail Levin Richmond

I. Overview of Choices and Factors

A. Available entities

1. One owner
   a. C corporation
   b. Pass through entity
      i. S corporation
      ii. Proprietorship

2. Multiple owners
   a. C corporation
   b. Pass through entity
      i. S corporation
      ii. Partnership--general and limited

B. Time for making choice

1. Formation of venture

2. After period of operation
   a. Expected results obtained
      i. Conventional wisdom often suggested using a pass through entity during a venture's early years and switching to C Corporation status after a desired level of profitability had been reached. Planning for the initial choice of entity often included the possibility of such a later switch.

      a. A switch to C Corporation status involved minimal tax consequences because of §351. Depreciation and investment credit recapture could be avoided, and even ACRS status carried over to the new entity by virtue of §168(f)(10).
ii. At least since 1982, planners might have contemplated an ultimate switch back to pass through entity status


b. Unexpected change in operating environment

i. Risks of business, perhaps coupled with insurability problems, may necessitate switching to corporate form, either C or S.

ii. Change in tax laws, other government regulations, or community values may allow change--e.g., certain professional groups are allowed to begin operating in corporate form or client sentiment no longer militates against using corporate entities.

C. Factors influencing choice

1. Nontax. See Outline section II.

2. Tax

a. Federal taxes--factors including rates, capital gains, double taxation, and fringe benefits are discussed in outline sections III through VIII.


II. Nontax Factors Influencing Choice

A. Traditional advantages of corporate form

1. Limited liability

a. C corporations share this advantage with S corporations and with limited partnerships.

b. This is generally a meaningless advantage for closely-held entities because creditors require guarantee of entity debt before extending credit.
c. It is useful only to protect against tort liability if owners have observed entity formalities and other requirements of state law. This benefit may be further limited for professional corporations in situations involving malpractice.

2. Centralization of management

a. C corporations share this advantage with S corporations, proprietorships, and, to lesser extent, with limited partnerships.

b. It is important in general partnerships only if some owners will be excluded from decisionmaking or other indicia of management.

3. Transferability of ownership interests

a. C corporations allow for greatest theoretical leeway in transferring ownership interests.

i. Unless the partnership agreement provides otherwise, partnership interests can be transferred only with consent of other partners, at least to the extent a general partner's status is involved. Unif. Partnership Act § 18(g).

ii. Any transfer of a proprietor's obviously interest transforms the business into new entity.

iii. S corporation transfers are restricted by list of transferees who would cause the S election to terminate. § 1361(b).

a. thirty-sixth shareholder

b. nonqualifying trust

c. nonresident alien

d. These problems can be minimized through use of well drafted shareholder agreements. Whenever possible, the agreement should provide which spouse will retain stock ownership after a divorce. It might also be wise to plan for the death of owners with large family groups as potential heirs.

b. Leeway is mainly theoretical for any closely-held corporation because owners should have provided their own restrictions limiting transferability to outsiders. Even draconian restrictions should allow continued corporate status if other corporate attributes exist. Reg. § 301.7701-2(e).
c. C corporation transferability is also restricted by state law when professional corporation is involved. New owners generally must be licensed in the particular profession. States vary as to which professions are covered by such rules.

4. Continuity of existence

a. Corporation theoretically has infinite life because withdrawal, death or bankruptcy of owner does not automatically dissolve entity.

i. Partnership dissolution does not require termination under
   a. state law--Unif. Partnership Act § 41; or
   b. federal income tax--§§ 706(c)(1) & 708(b).

b. Although infinite life is available for S as well as C corporations, an S corporation is subject to restrictions on operation of business that could result in its being "involuntarily converted" into a C corporation:

   i. formation of 80%-owned subsidiary--§ 1361(b)(2);
   ii. purchase of S corporation stock by another corporation--§ 1361(b)(1)(B);
   iii. entrance into business prohibited S corporation status, such as banking or insurance. See, e.g., § 1361(b)(2)(B)-(E);
   iv. acquisition of shares by nonqualifying trust, nonresident alien, or 36th shareholder.

c. Continuity of existence, particularly in a personal service corporation, may depend more on the owner remaining active in the business than on legal formalities.

5. Flexibility as to capital structure--equity

a. C corporations can have multiple classes of ownership interests, while general partnerships and S corporations have less freedom.

b. Since 1982, S corporations can restrict voting rights by issuing nonvoting common stock or common stock with less than full voting rights. See § 1361(c)(4). Limited appreciation rights are not possible, however. This factor is important in an estate planning context but also may be of interest in the reverse situation.
Those active in the business may wish to reap a greater portion of its future success but are willing to share its current success pro rata. They can afford to share current profits pro rata because they also receive salaries, which will end with their retirement. This scenario is more likely when there is no pension plan.

c. Partnership can allocate income/loss items so long as there is substantial economic effect. § 704(b). This translates into value of particular partnership interest.

d. Limited partnership can also be used to create interests that share in appreciation more than do others.

6. Flexibility as to capital structure--debt

a. All entities are capable of issuing debt instruments if "guaranteed" repayment of investment is desirable. This may also entail better tax consequences, particularly for C Corporation shareholders, than do equity investments.

b. Outside creditors may require subordination of these loans to their own, particularly in corporate form where limited liability is available to owner/creditors.

c. In addition, S Corporation debt cannot be too creative in its terms so that there is no question of it being a second class of stock. § 1361(c)(5).

7. Formation costs

a. Documents must be filed with the appropriate authorities for C Corporation, S Corporation and limited partnership.

i. S Corporation must also file election documents with IRS in timely fashion. § 1362(b).

b. While a general partnership may be required to file only a fictitious name certificate, a well-drafted partnership agreement solves many problems that could arise at a later date. Shareholder agreements in addition to provisions in the Articles may also be advisable.

8. Accounting costs

a. Accounting method. If a C Corporation is forced to use the accrual method for tax purposes (See Outline
section VI), it may also switch to that method for accounting purposes as well. The closely-held C Corporation may not be able to afford the complexity of two sets of books; the extra cost of accrual accounting will be enough of an annoyance.

b. Tax return costs cause problems for each type of entity.

i. Pass through entities have more difficult tax returns—allocation of specially treated items, preparation of information returns for each owner.

ii. Work on pass through entity's return can delay completion of owner's Form 1040. This may be a particularly onerous problem if fiscal year entity is forced to adopt calendar year end.

iii. If C Corporation salary determinations are made with a view to balancing corporate and shareholder taxable income, risk of audit and penalty taxes is increased and psychic energy is consumed.

iv. The corporate minimum tax computations will also increase compliance costs for C Corporations. See Brown & Mason, "Temporary Regs on the Corporate AMT Book Income Adjustment Are Issued," 67 J. Tax'n 72 (1987), discussing Reg. § 1.56-1T.

III. Tax Rates

A. Pre-1986 rules

1. The top 1954 Code rate imposed on C Corporations was lower than that imposed on individuals until the 1986 Act reversed that relationship.

2. This factor's importance has been declining for several years.

a. Spread was almost 40 percentage points in the early 1960's.

b. Tax rate reductions, both individual and C Corporation, since then greatly reduced the spread of top tax brackets. At the end of the 1954 Code era, the spread between the top brackets was only 4 percentage points—50% individual versus 46% corporate. 1954 §§ 1 & 11.

i. in addition, individual rates were indexed, corporate rates were not, by ERTA. 1954 § 1(f).
3. Even if rates are the same, the C Corporation allows its owners to use the bottom brackets twice, once for income paid as interest, rent, or salary and once for income retained in the corporation.

   a. Because this technique does not work for dividend distributions, the advantage was lost for corporations whose owners needed distributions exceeding amounts they could justify as rent or salaries.

   b. In 1984 this technique was cut back by 1954 § 11(b), which phased out the lower corporate rates once taxable income exceeded $1,000,000. This reduced the effect of using two sets of brackets by flattening rates and raising the effective rate of corporate taxation.

4. Corporate capital gains rates were less generous than individual rates--28% maximum (1954 § 1201) versus 20% (1954 §§ 1 & 1202)--an important factor if corporate gain recognition was expected.

5. The minimum tax was imposed at a higher level on individuals--20% (1954 § 55) versus 15% (1954 § 56)--than on C Corporations. In addition, pass through entities passed their preferences through to be added to the owner's own preferences in determining this tax.

B. Effect of 1986 act

1. The rate spread now favors pass through entities for large amounts of income.

   a. The top individual rate is 28% in 1988.

   b. The top corporate rate of 34% is already in effect.

   c. Both groups have extra 5% rates used to phase out benefits of bottom brackets

      i. The individual phase out begins at $71,900 on a joint return and its extent is determined in part by the number of exemptions. § 1(g).

      ii. The C Corporation phase out begins at $100,000. § 11(b).

2. C Corporations have lower tax bracket for small amounts of taxable income than do individuals and could yield some savings using the bottom brackets twice.
a. Accumulations up to $50,000 per year are taxed at a flat 15% rate. Married individuals leave the 15% bracket at incomes of $29,750. Corporations also can use a 25% bracket for incomes between $50,000 and $75,000. §§ 1(a) & 11(b).

b. This technique requires that the present value of later tax liability be less than the present value of the amount saved through corporate accumulations.

c. Methods previously used to insure that difference -- capital gains rates, General Utilities gain forgiveness, death of the owner--have been repealed or are under attack. See discussion in Outline sections IV and V.

d. The dividends received deduction (§ 243(a)) could still be used to shelter corporate income at virtually no tax, thus increasing the present value of the corporate saving.

i. Even in the top bracket of 34%, the tax rate would be only 6.8% on the 20% of the dividends subject to tax.

ii. This technique is not risk-free.


b. The § 541 tax on personal holding companies could be a factor in the closely held C Corporation although its bite is limited.

c. If the securities appreciate significantly, there will be a large tax liability due when the corporation sells them or distributes them to shareholders.

d. The benefits will be substantially reduced if the stock is debt financed. § 246A.

iii. In addition, the gross amount of the dividend (net of income tax) is included in C Corporation earnings and profits. This is important

a. as measure of future dividend taxation. §§ 301 & 316(a)(1); and

b. if corporate alternative minimum tax uses E&P as
its base. § 56(c)(1)(B)&(g).

3. Although the capital gains preference is repealed, the operative rules remain in the Code pending inevitable rate increases. The maximum corporate rate of 34% still exceeds the top individual rate of 28%. §§ 1(j) & 1201(a).

4. The corporate minimum tax has been significantly strengthened. While its 20% rate is currently 1 percentage point below the individual rate, there is no guarantee even this small a differential will continue.

IV. Income Splitting Among Multiple Taxpayers

A. Pre-1986 rules

1. As noted in Outline section III, the existence of C Corporations as separate entities allowed use of bottom rate brackets twice--at entity level and at owner level.

2. Even if no salary were paid, so that the sole bracket used was the corporation's, it was likely to be lower than the individual owner's in a highly profitable corporation. This difference became less important in 1981, when the top individual bracket dropped from 70% to 50% for all income.

3. Pass through entities could use a form of income splitting, not with the entity, but with family members in lower brackets than those of the principals. In effect, the principals undercompensated themselves to produce an overall tax saving.

a. This technique came under attack long before the 1986 Act.

i. Congress stopped use of the standard deduction against unearned income for taxpayers who were tax return dependents. 1954 § 141(e), replaced by similar rules for the zero bracket amount in 1981. 1954 § 63(e)(1)(D).

ii. The Code also limited the amount of shifting by authorizing allocation within the group:

a. § 704(e) for partnerships;

i. Where a gift is involved, income shifting requires ownership of capital interest and capital must be a material income producing factor.
ii. There must be reasonable compensation allocated to donor's services.

iii. The distributive share allocated to donated capital cannot be disproportionately greater than the share allocated to the donor's capital.

b. § 1366(e) for S Corporations requires allocation of reasonable income to family member rendering services or providing capital.

b. The era of high divorce rates also limited the efficacy of this device, particularly for the S Corporation which is also subject to stock ownership limitations (Outline section II).

c. Further limitations involved creditor restrictions on distributions. If a pass-through entity had an undistributed profit, owners would be taxed on funds they did not receive. Non-principals might not appreciate this aspect of the equity interest they had received.

B. 1986 act changes

1. Changes favoring pass-through entities

a. Compression of rate schedules--reduction in number of brackets and in spread between top and bottom brackets--reduces amount of current savings possible.

i. If pass through entity used multiple owners to split up tax burden, the advantage of this technique would be reduced for the same reason.

b. Repeal of General Utilities doctrine creates an additional taxpayer at distribution (or liquidation) by C Corporation. Rather than merely sharing in the overall tax burden, this entity adds an additional round of taxation. See Outline section V.

2. Changes with mixed impact

a. Repeal of personal exemption for tax return dependents--if these individuals own interests in pass-through entities, they are more likely to be taxed on their share of entity income. § 151(d)(2).

b. Allowance of $500 standard deduction against unearned income will allow limited amounts of such income to escape taxation. §63(c)(5).
c. Kiddie tax—if children under 14 already own interests in pass through entities, unearned income above the standard deduction plus $500 will be taxed at the parent's rate. § 1(i). This result is no worse than the parent continuing to own the interest and at least is self-limiting in time.

i. There is no kiddie tax problem if a trust was used to hold the minor's interest in a partnership, unless it was required to distribute all income currently. So long as distributions were made by age 21, the tax on accumulation distributions could also be avoided. § 665(b).

ii. The discretionary trust device was unavailable to the S Corporation.

iii. For newly established pass-through entities, the kiddie tax can be avoided by making no transfers to children under 14. There is no point in making such transfers for a loss entity, as the loss pass through is more important to the parent.

   a. The parent presumably has other income exceeding the exemption and standard/itemized deductions.

   b. A high income parent may have already lost exemptions through phase-out of the 28% bracket. § 1(g).

iv. The kiddie tax is not a problem if a C Corporation is used unless it is paying significant dividends.

   a. A large dividend payout is inadvisable in any event because of double taxation.

   b. Repeal of the dividend received exclusion ends any reason to pay even small amounts.

v. The kiddie tax is more likely to be a problem for all entities, not because of children's equity interests, but because children are receiving rent or interest from entity.

   a. There is no double tax—C Corporation is deducting the payments; pass through entities pay no tax.

   b. If there is a profit, children are taxed at parent's rate.

   c. If rental activity yields a loss, the loss is probably wasted on children or invokes passive activity rules. § 469.
V. Avoiding Tax on Entity Appreciation

A. Factors involved

1. Five factors combined to make the C Corporation appealing: capital gains rates; the General Utilities doctrine; stepped-up basis at death; deferral; and the dividends received deduction.

2. These factors were often used in conjunction with those already discussed.

3. C Corporations were also useful in the estate planning area, through recapitalization freezes.

B. Capital gains

1. Use of capital gains rates allowed shareholders to extract C Corporation profits at rates lower than those imposed on owners of pass through entities.

   a. If owner of a pass through entity were in the top bracket, earnings would yield fifty cents on the dollar after federal income taxes were subtracted.

   b. If these earnings were retained in a C Corporation, taxes would take no more than forty-six cents. The remaining fifty-four cents could ultimately be distributed to a shareholder at capital gains rates when he disposed of his interest in the entity.

      i. Because the top capital gains tax rate was 20%, the shareholder would net at least forty-three cents if the earnings had not been reinvested. This is a net loss, however.

      ii. If the shareholder were in a lower rate bracket during the earnings extraction period, he might be able to increase his net return to exceed fifty cents, but this would require spreading the gain over several years.

   c. This factor had already declined in importance by 1981, when Congress reduced the top tax rate to 50% for all types of income. When the top individual rate was 70%, this technique was invariably profitable.

2. Repeal of capital gains rates, while likely a temporary phenomenon, nullifies this factor's benefit.

C. General Utilities doctrine

1. This doctrine was used to avoid double taxation on distributions or liquidating sales of corporate assets.
So long as appreciated property could be disposed of by the corporation with no tax consequences, double taxation of corporate profits could largely be avoided. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

a. This doctrine had been severely limited even before the 1986 Act limited its use in nonredemption distributions.

i. Its use in redemption distributions was attacked beginning in 1969. 1954 § 311(d).

ii. Its use in liquidating distributions was limited by court decisions recognizing that depreciation recapture and other accounting method limitations applied.

b. S Corporations and partnerships did not need the doctrine to avoid double taxation because only one level of tax was imposed.

i. Partnerships could actually improve on the doctrine's results by distributing appreciated property pro rata to partners.

a. No partnership level tax resulted. § 731(b).

b. No partner level tax resulted even if the individual partners lacked adequate basis to absorb the distribution. § 731(a).

c. Individual partners could then decide when to recognize the gain potential inherent in the property, usually at capital gains rates, or could hold it until death and pay no income tax.

d. Even inventory assets could be sanitized if the partner was willing to hold them for five years. § 735(a)(2).

ii. S Corporations did not fully share this partnership attribute, as entity gain recognition resulted under § 1363(d).

2. The 1986 Act eliminates these C Corporations after 1988. §§ 311(b) & 336. It is speculative to guess whether it will be reinstated, as its repeal had been urged long before the 1986 legislation.

D. Death

1. Owners of all entities benefited from death, or at least their heirs did, because untaxed appreciation in
their ownership interests was wiped out by the fresh start basis of § 1014.

a. Elimination could be total under § 1014(a)(1)-(2) or partial if special use valuation allowed reduction in the estate tax value under § 2032A. § 1014(a)(3).

b. C Corporation shareholders arguably had the greatest stake in death because they had not increased their equity basis by undistributed entity profits. Cf. §§ 705(a)(1) & 1367(a)(1).

2. Death remains an important factor aiding shareholders of C Corporations. However, its long term viability is not assured.

a. § 1023, an idea whose time had not then come, would have imposed carryover basis at death. Although deemed unacceptable at the time, the impact of this rule would have been blunted by the low capital gains rate then in effect.

b. Taxation of unrealized gains at death is once again being discussed in Congress.

E. Deferral

1. To the extent tax could be deferred on appreciated assets until gain was realized, it was a neutral factor in choice of entity.

2. Deferral of higher rates on operating income was a characteristic of C Corporations before the 1986 Act.

a. Because the top corporate rate was lower than the top individual rate, imposition of the higher individual rates could be deferred until a later date when an actual distribution occurred. Deferral of this sort allowed the entity to reinvest the unpaid tax, which could increase in value enough to wipe out the later tax liability. This was much easier to do when the top individual rate was quite high, a low capital gains rate was available for realized retained earnings, and avoidance of double tax on distributions was possible.

3. The 1986 Act may have temporarily erased the benefits of the deferral technique by reducing the top individual rate below the top corporate rate, repealing the capital gains preference under the current rate structure, and repealing General Utilities.
a. Using 1988 rates, a 15 year accumulation, and 10% annual appreciation, one analysis shows a net loss for reinvested earnings of a C Corporation compared to the results obtained using a pass-through entity. See Eustice, Kuntz, Lewis & Deering, The Tax Reform Act of 1986, Warren, Gorham & Lamont (1987) at 2-10 to 2-11 (Table 2-3).

F. Dividends received deduction

1. C Corporations could deduct 85% of dividends received from other corporations in computing their taxable income.

   a. This deduction was denied S Corporations and partnerships, both of which compute their income using the individual model. §§ 703(a) & 1363(b).

   b. Pass through entities passed dividend income through to their owners as separately stated items eligible only for the $100 or $200 dividend received exclusion of § 116.

2. Even if taxed at the highest marginal rate, the 15% of the dividend remaining in the tax base caused an effective rate of only 6.9%.

3. By investing surplus funds in such shares, C Corporations could increase the corporate assets. If the shares themselves happened to increase, that enhanced the effect of the untaxed dividends. However, because of the potential for depreciation in value (to be disposed of using the unfavorable corporate capital loss rules), stable price and dividend payments would be preferred over growth potential.

4. This technique was not risk free for the closely-held C Corporation.

   a. Imposition of the accumulated earnings tax or the personal holding company tax was possible; and

   b. Corporate earnings and profits increased by the full dividend amount, net of the corporate tax paid.

5. The 1986 Act cuts this technique back slightly and may no longer favor the C Corporation in the current environment.

   a. The individual dividends received exclusion is repealed.
b. The C Corporation's dividend received deduction is reduced to 80%, causing a 6.8% top effective tax rate at current rates. While this is not significantly different from the top effective rate under pre-1986 rules, it gives a much lower saving when compared to the top individual rate of 28 (or even 33)%.

c. One computation projects 5 year savings from use of this technique as compared to the results obtained from a pass through entity. The pass through entity yielded 10% better results than a C Corporation which retained its earnings. The savings was cut approximately in half when the corporation purchased dividend paying stock. See Horvitz & Hebble, "The Effect of the Section 531 Penalty on Accumulations of Earnings and Profits After TRA '86," 14 J. Corp. Tax'n 236, at 240 (1987).

d. This technique would become more valuable

i. if capital gains rates are restored; or

ii. if General Utilities is reinstated.

e. It would be less valuable if gains are taxed at the shareholder's death.

VI. Taxable Year and Accounting Method

A. Taxable year

1. Pre-1986 rules

a. C Corporations could select any taxable year (calendar, fiscal, 52-53 week) for their first taxable year. § 441(b). Later changes in taxable year required IRS permission. § 442.

i. Because cash method owners were generally taxed on distributions and other payments only when they received these amounts, a corporate fiscal year did not automatically confer tax benefits.

ii. Some deferral benefit might arise from a January year end if salary or bonus arrangements were not finalized until the corporate year end. However, this type of arrangement works only if the shareholder has adequate resources to sustain himself during the year. If these resources flow from the corporation as loans or advances, pre-year-end constructive receipt may be alleged.
iii. A more valuable deferral technique, involving the accrual method corporate payor and the cash method owner-employee, is not dependent upon choice of tax year for its utility. Unfortunately, § 267 exists to limit that device's use.

b. Pass through entities had less flexibility.

i. An S Corporation's ability to select a taxable year was limited in 1982.

   a. Newly electing S Corporations (and existing S Corporations whose ownership shifted by more than 50%) had to adopt a permitted year. § 1378(a).

   b. Permitted years included calendar years and years for which the corporation established a business purpose. § 1378(b).

ii. Partnerships had long been subject to § 706 limits requiring a business purpose for using a year which did not coincide with that of the principal partners.


2. 1986 Act changes

a. Personal service C Corporations must now adopt a calendar year unless they can establish a business purpose for a fiscal year. § 441(i).

i. These corporations are defined using § 269A definitions with modifications:

   a. Corporation the principal activity of which is the performance of professional services and such services are substantially performed by employee-owners. § 269A(b)(1).

   b. employee-owner: any employee who owns, on any day during the taxable year, any of the outstanding stock of the personal service corporation. Section 318 rules will be applied without a minimum ownership needed to trigger attribution. These rules are modified from those in § 269A(b)(2). Congress contemplated also requiring more than 10% aggregate ownership by employee-owners so a technical corrections bill may amend this section. General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess. (1987) at 536 (Comm. Print).
ii. Deferral of income is not a qualifying business purpose. § 441(i)(1).

b. Many S Corporations will lose their grandfathered fiscal years because deferral is specifically proscribed as a business purpose. § 1378(b).

c. Partnership also must establish a business purpose other than deferral (§ 706(b)(1)(C)) or adopt one of the following, in order of preference under § 706(b):
   i. the taxable year of one or more of its partners who have an aggregate interest in partnership profits and capital greater than 50%;
   ii. the taxable year of all the principal partners (those having a 5% or greater interest in capital or profits);
   iii. the calendar year or a year prescribed in the regulations.


B. Accounting method

1. Pre-1986 rules. Each entity could adopt the accounting method of its choice so long as the method clearly reflected income. § 446(b).

2. 1986 Act Changes. The cash method is proscribed for C Corporations (and for partnerships with C Corporation partners) unless one of two § 448 exceptions applies:
   a. The corporation is a qualified personal service corporation. § 448(b)(2).
      i. Qualifying personal services are health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting. § 448(d)(2)(A).
a. Athletic services are among the groups that do not qualify. Reg. § 1.448-1T(e)(4)(iii).

ii. Substantially all the corporation's activities must involve performance of these services.

iii. Substantially all of the stock (based on value) must be held by employees performing these services for the employer. Retired employees and employee's estates are also permissible owners. Others receiving stock from a deceased employee are permissible owners for up to 2 years following death.


b. The corporation's gross receipts (net of returns and allowances) did not exceed $5,000,000 for all prior years beginning after December 31, 1985. A three-year averaging look-back convention is used to compute each year's receipts. § 448(b)(3)&(c).

c. Although no accrual is required for uncollectible amounts (determined based on experience), this exception relates only to amounts due for the performance of services. § 448(d)(5).

VII. Fringe Benefits and Pension Plans

A. Fringe benefits

1. Certain fringe benefits are deductible by the entity only if the recipients are "employees" without resort to § 401(c)(1). The most important benefits involved are

a. accident and health insurance plans--§ 105(g).

i. disability coverage

ii. medical insurance and reimbursement plans

b. employee death benefits--§ 101(b)(3) allowing for certain benefits as part of retirement plans.

2. Other fringe benefits, including group legal services plans (§ 120) and educational plans (§ 127) include self employed individuals within the eligible group.
3. Even though S Corporation shareholder may render services as an employee, the partnership fringe benefit rules apply if he owns (either actually or constructively) more than 2% of the outstanding stock or voting power on any day of the corporation's year.

4. The C Corporation may allow for more fringe benefits to be provided owner employees, but nondiscrimination rules now apply in the various fringe benefits provisions. In addition, § 89, added in 1986, will include excess benefits in a highly compensated employee's gross income.

5. For the next two years, and perhaps even permanently, § 162(m) allows self-employed individuals to deduct 25% of health insurance costs as a business deduction.
   a. This deduction is also subject to § 89.
   b. No § 162(m) deduction is allowed if the taxpayer is eligible to participate in a subsidized health plan maintained by his employer or his spouse's employer.

B. Pension plans

1. In recent years contribution limits for self employed individuals have been brought closer to those available to employees.

2. There are still some benefits for employees of C Corporations which are willing to set up plans that meet nondiscrimination rules.
   a. A C Corporation plan is apparently able to make loans to plan participants in situations where a partnership and S Corporation are not. § 4975(d).
   b. Corporate defined contribution plans use the employee's gross salary in determining the employer contribution. Owner-employees are limited to contributions based on earnings net of the contribution itself. §§ 401(c) & 404(a)(8).

3. Only C Corporations can have ESOP's, which may be of some interest if corporate stock will be a large portion of the owner's gross estate and family members are not inclined to keep control of the business. § 2057.

4. Limited C Corporation pension advantages are available only if the owners are willing to cover employees in a manner that is nondiscriminatory. This will vary from business to business depending on the employee mix and the owners' personalities.
VIII. Passive Loss and Similar Limitations

A. 1954 Code

1. The 1954 Code contained various limits on taxpayers' ability reduce their tax burden through deductions many consider dubious.

2. In addition to the minimum tax, designed to ensure some degree of participation by everyone, these limitations include at-risk rules, hobby loss provisions, home office and luxury car rules, and limits on accruing expenses before economic performance has occurred.

B. 1986 Act changes

1. The 1986 Act tinkered with many of the above items in addition to adding new ones.

2. Passive loss limitations prevent affected taxpayers from offsetting net passive losses against business and portfolio income. § 469.

a. These rules apply to

i. individuals—including losses passed through from pass-through entities;

ii. closely-held C Corporations as defined using the definition in § 465(a)(1)(B);

a. C Corporations meeting the stock ownership requirements of § 542(a)(2): ownership at any time during last half of year by 5 or fewer individuals of more than 50% in value of the stock.

iii. personal service corporations using modified version of definition in § 269A(b): principal corporate activity is performance of personal services, which are substantially performed by employee-owners. Employee-owners include any employee who owns any stock during the year, using § 318 attribution rules (with no minimum ownership needed to cause attribution). However, a corporation is not a personal service corporation unless employee-owners own more than 10% of stock value.

b. To avoid characterization as a passive activity, taxpayer must show material participation on a regular, continuous, and substantial basis. § 469(h)(1).
i. Limited partners generally cannot show this.
   § 469(h)(2).

ii. Closely-held C Corporations and personal service
corporations will have material participation if
one or more shareholders owning more than 50% of
stock value materially participates.
   § 469(h)(4)(A).

iii. Closely-held C Corporations which are not
personal service corporations can also qualify
with respect to an activity meeting the tests of
§ 465(c)(7)(C)(i)-(iii):

a. there was at least one full-time employee
   substantially all of whose services were in the
   active conduct of the business throughout the 12
   month period ending with year-end;

b. during the same period there were at least 3
   nonowner employees substantially all of whose
   services were directly related to the business;
   and

c. amount of § 162 and § 404 deductions
   attributable to such business exceeds 15% of
gross income from the business for that year.

iv. Closely-held C Corporations which are not personal
service corporations can also deduct their passive
losses against net active income (taxable income
before consideration of passive activity income or
loss and portfolio income or loss). § 469(e)(2).

c. Individuals, but not C Corporations, can offset up
to $25,000 of rental losses through active
participation in the rental activity. § 469(i)(1).

d. Because some C Corporations will be able to offset
business or portfolio income by passive losses, this
may be perceived as a means of avoiding double
taxation of corporate earnings.

i. A corporation can initially reduce its tax burden,
but eventually the passive activity may become
profitable. This could result in a higher
corporate level tax than would be imposed at the
individual level.

ii. A later distribution or sale of the passive
activity could be taxed without benefit of capital
gains rates and at both the corporate and
shareholder level. Since losses were previously
deducted, suspended losses will not be available to offset corporate gains.

3. Investment interest expense limitations were tightened by the 1986 Act, phasing out the deduction for up to $10,000 in net interest expenses. These limitations do not apply to C Corporations, but limited tax savings flow from this. See also § 246A, reducing the dividends received deduction for debt financed portfolio stock.

IX. Choosing the Appropriate Business Form

A. New businesses

1. Participants expect initial losses
   a. The owners are well advised, at least for federal tax purposes, to choose a pass through entity if state law allows one of these forms.
      i. The losses will pass through to the owners for immediate use.
      ii. Even if one or more owners runs out of basis (or amount at risk), these losses will be suspended for their future use.
         a. If the entity never reaches profitability, any remaining loss will also be deductible.
         b. § 1244 will allow the original shareholders to escape the $3,000 capital loss limitation still in § 1211.
      iii. If the owners later desire to change to C Corporation status, that can be accomplished with minimal cost.

2. Participants contemplate immediate profits
   a. Unless Congress acts to reinstate some or all of the factors which made C Corporations attractive, few new businesses should consider this form for tax reasons.
   b. While some initial tax saving is possible if modest earnings are retained, the long range result is not as favorable as that obtained with a pass through entity.
   c. If large sums are retained in the corporation, the corporate tax may exceed the tax that would have been imposed on the owners of a pass through entity.
B. **Existing business**

1. **Loss entities**

   a. If a loss entity is already organized as a pass through, it probably should retain this status.

   i. Electing C Corporation status prevents carrying unused prior operating losses past the S Corporation's post termination transition period. If no basis is acquired in that period, which may be only a year, then no deduction will be allowed. § 1366(d)(3).

   ii. Even though inadequate basis prevents current deduction of loss attributable to partnership or S Corporation, the loss is merely suspended and not permanently forgone. §§ 704(d) & 1366(d). Basis can be restored by:

      a. operating profits, which will then be effectively tax sheltered, or

      b. additional contributions to capital or even loans to the entity in the case of an S Corporation.

   b. If the loss entity is already organized as a C Corporation, the decision involves its past and future profit potential.

      i. If i+ has never been profitable, it has no prior earnings to absorb its net operating loss.

      ii. These losses will not carry over to S Corporation years, so an S election before the entity turns profitable makes past losses essentially worthless. § 1371(b).

      a. It is possible that the present value of immediate deductions for continued losses will exceed the value of ultimately deducting the deferred loss. In that case, conversion to a pass through entity would be advisable.

      b. Conversion would not be without cost, however.

         i. Unless § 1244 applied, shareholder loss deduction might be limited to $3,000 per year capital loss.

         ii. Any current shareholder loss requires a liquidation. If the liquidation were immediately followed by incorporation as an S Corporation, it might be ignored for tax purposes.
iii. An S election could trigger the application of § 1374 for built in appreciation on corporate assets once the transition relief period for long term capital gains is over. That would at least be offset by the otherwise disallowed operating loss from the C Corporation period. § 1374(b)(2).

iii. If it is turning profitable, the owners must choose between sheltering the prior NOL at the entity level (continue as C Corporation) and risking that they have misjudged earnings potential and converted too late, trapping earnings in the C Corporation shell.

2. Profitable Entities

a. Pass through entity. These entities are generally well-advised to retain pass through status unless it appears Congress is ready to once again favor C Corporations. Switching to C Corporation status, only to switch back in a few years, enriches lawyers and accountants without doing much for many of the owners.

b. C Corporation

i. A switch to pass through status will be justified over the long run if present tax rules survive.

ii. However, the switch will entail transaction costs as well as the § 1374 problem if an S Corporation is chosen.

iii. Since most C Corporation benefits were cut back in 1981 and 1982, existing C Corporations may reflect owner inertia, but one of the few remaining benefits may be involved in the owners' decision. Before suggesting a change, be reasonably certain you will not be reversing the transaction before its full benefits have been realized.