Understanding the Entities

Choosing the Right Business Types when Making an Acquisition

When you're looking to buy a business, you have to understand the type of business entity, especially for tax purposes. There are four basic types of entities that can be used to buy and run the business:

- *C Corporation*;
- *S Corporation*;
- *Partnership* – General or limited; or
- *Limited Liability Company (LLC)* – this is a hybrid entity that offers the legal insulation of a corporation and the preferred tax treatment of a limited partnership. This is available in all 50 states and the District of Columbia.

TAX DIFFERENTIATION

The main difference between these four types of business entities is in how each pays taxes. For example, a C Corporation is a separate taxpaying entity, meaning its earnings are taxed to the corporation when earned and again to its shareholders upon distribution.

S Corporations and partnerships are taxed directly to the partners or shareholders, regardless if distributed or otherwise made available to such persons. Additionally, they may distribute their earnings to the equity owners free of tax. These two entities alongside LLC's are generally exempt from tax, but pass the tax liability with respect to such earnings directly through to their owners – otherwise known as "pass-through entities."

C Corporation

The Internal Revenue Code (IRC) defines this as any corporation that is not an S Corporation. It generally excludes corporations granted special tax status such as life insurance companies or those qualifying as real estate investment trusts (REITs).

S Corporation

This is a regular corporation that meets certain requirements and elects to be taxed under Subchapter S of the IRC. Originally called a "small business corporation," the S Corporation was designed to permit small, closely-held business to be conducted in corporate form, while continuing to be taxed generally as if operated as a partnership or an aggregation of individuals. The eligibility requirements impose no limitation on the actual size of the business in question that seeks to be an S Corporation.

For a business to be considered an S Corporation, it may not:

- Have more than 75 shareholders;
- Have as a shareholder any person (other than an estate and a very limited class of trust) who is not an individual;
- Have a non-resident alien as a shareholder;
- Have more than one class of stock;
- Be a member of an affiliated group with other corporations;
- Be a bank, thrift, insurance company or certain other types of business entity.

Partnership

This entity must be an actual general or limited partnership under applicable state law. It is an alternative to the S Corporation with several advantages. There are no restrictions on the structure or composition of the acquired corporation's ownership; therefore, it can be used when the S Corporation is unavailable for technical reasons.

Additionally, the partnership is unique in enabling the partners to receive distributions of loan proceeds free of tax. In the event that the business is expected to generate tax losses, then a partnership is better suited than an S Corporation to pass these losses through to the owners.

LLC

Under most state laws, this entity may merge with or into a stock corporation, limited partnership, business trust or another LLC. All members of one must approve the merger unless they agree otherwise.

Corporate Tax on Income

In practice, no corporate tax should be paid on generated income from the business, which is why a pass-through entity owned by individuals should be the structure wherever possible. This means that the vehicle for making a purchase on a business would either be a partnership or an S Corporation.

If the business is a C Corporation, whether acquired through an asset or stock purchase, should be operated as a division of the buyer or through a separate company included in the buyer's consolidated return. In either case, the income of the business will be subject to only one level of corporate tax prior to dividend distribution from the buyer to its shareholders.