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U.S.

Startups Discover the Allure of the ‘C Corporation’

The corporate structure is gaining new attention among companies after changes in the tax law created the potential for big savings

John Bisges and his nephew, Aaron, are launching a new brewery this year with a corporate structure known as a ‘C corporation.’
PHOTO: DUSTIN CHAMBERS FOR THE WALL STREET JOURNAL

By Richard Rubin

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Some startups are looking for a windfall in tax savings by adopting a corporate structure that until recently made little sense for any but the largest, publicly traded companies.

For John Bisges it was a pretty easy decision. The Georgia businessman is launching a new brewery this year with a corporate structure known as a “C corporation.” It could allow him the

best of two worlds: A low 21% corporate tax rate created in President Trump's 2017 tax law, and a generous capital-gains tax exemption championed by President Obama.

For years, Mr. Bisges started ventures using limited-liability companies, known for their flexibility and tax advantages. But when Mr. Bisges and his nephew, Aaron, started planning StillFire Brewing, their accountant suggested the C corporation.

Mr. Bisges is pinning this part of his business plan on Section 1202 of the Internal Revenue Code, an underused provision expanded under Mr. Obama, and one that is gaining new attention after the 2017 Tax Cuts and Jobs Act made it more attractive.

The strategy is particularly advantageous for business founders who expect to start small, keep earnings inside the company, make annual profits and then cash out. If a taxpayer holds C corporation stock for five years and follows the technical rules, capital-gains taxes on a subsequent sale get erased—on gains up to $10 million or 10 times the original investment, whichever is greater.

"What's really nice is being able to eliminate that amount of gain from being taxed at any level," said Warren Kean, a lawyer at Shumaker, Loop & Kendrick in Charlotte, N.C.

For years, Mr. Bisges started ventures using limited-liability companies, known for their flexibility and tax advantages. PHOTO: DUSTIN CHAMBERS FOR THE WALL STREET JOURNAL

Decades ago, even small businesses commonly structured themselves as C corporations, under which income is taxed twice: once at the corporate tax rate and then again when dividends are distributed to shareholders or when stock is sold for capital gains. When individual tax rates were significantly higher before the 1980s, being a C corporation made more tax sense.

But steep tax-rate cuts for individuals in the Reagan era helped make so-called pass-throughs the default business structure. Pass-through businesses such as partnerships, S corporations

and LLCs face just one layer of taxation when business income passes through to their owners' individual tax returns.

Until 2017, the C corporation structure rarely offered advantages, except for businesses that wanted venture-capital funding or were headed for an initial public offering.

That changed after Mr. Trump's 2017 tax law lowered the corporate tax rate. Analysts speculated about the prospect of businesses switching their structures to take advantage, especially those that couldn't qualify for the tax break Congress created for many pass-throughs.

Accountants and tax advisers say so far, that has happened rarely.

"Maybe it's just inertia," said Pat Tuley, a partner at Porter Keadle Moore who is advising the brewery. "People are kind of wed to their format that they're in."

Some startups, however, are now choosing C corporation status, with their advisers

The Tax Cuts and Jobs Act changed the calculation, making the 1202 strategy attractive for some business owners. PHOTO: DUSTIN CHAMBERS FOR THE WALL STREET JOURNAL

highlighting the advantages of Section 1202. Business owners can't be sure, of course, how long Congress will keep the 21% tax rate and that uncertainty is a consideration.

"If I've got a situation where I think it's appropriate, I actually pitch it," said Steven Klein of Sher, Garner, Cahill, Richter, Klein & Hilbert LLC in New Orleans. "They have some doubts that you're going to maintain the 21% rate. That's one of the linchpins of why it works right now."

Future moves by Congress could make people more likely to use Section 1202, however. Democrats have been considering sharp increases in tax rates on individual income and capital

gains but jumps in the corporate rate may be restrained by a desire not to create rate gaps with other countries.

“If personal tax rates go up a lot and corporate tax rates don’t go up a lot, that could create a strong preference for the corporate form,” said Michael Knoll, a University of Pennsylvania law professor who expects relatively few conversions to C corporation status at current rates.

Congress created Section 1202 in 1993, but it was limited largely to companies seeking venture-capital investors.

The capital gains exclusion originally only covered half of the gains and in many cases, it couldn’t save a business much money compared with operating as a pass-through.

Mr. Obama pushed for expansion during his 2008 campaign and Congress made the 100% exclusion permanent in 2015 at an estimated cost of $8.8 billion over a decade. The break will cost taxpayers about $1.3 billion this year, more than double what it cost in 2013.

Meanwhile, the top capital-gains tax rate rose to 23.8% from 15% in 2013, increasing the benefit of avoiding the gains tax.

SHOULD YOU C?

You could consider this C corporation strategy if you:

- Expect to turn profits
- Plan to hold the business for at least five years and then sell
- Think Congress will raise individual or capital-gains tax rates

You may not want to consider this strategy if you:

- Need to take annual distributions of profits
- Plan to hold the business until death
- Think Congress will raise the corporate tax rate

“It was kind of meaningless until maybe 2013,” Timothy Jessell, an attorney at Greenberg Traurig LLP, said of the provision.

Even with those changes, the prospect of paying up to 35% on annual profits was daunting. The Tax Cuts and Jobs Act changed the calculation, making the 1202 strategy attractive for business owners willing to wait out the five-year requirement.

“It’s not like a real-estate investment where you’re expecting returns year two or three,” said Seth Watson, who is starting the Distillery of Modern Art, an alcohol producer and event space in Chamblee, Ga.

The Section 1202 strategy doesn’t work for everyone. Like the new pass-through break, it comes with a list of businesses that aren’t eligible, such as consulting firms and medical practices. When the stock is issued, businesses can’t have gross assets exceeding $50 million. Buyers may ultimately pay less for the company because it can’t be structured as an asset sale where the buyer gets deductions, said Gregg Polsky, a tax law professor at the University of Georgia.

“When you put it all together, I just think it’s a scary proposition and you have to advise your client, tell them all the costs,” he said.

Business owners who are never planning to sell may not want to bother, because the potential capital-gains taxes are erased at death anyway.

It also may not be right for people who need to live off their business profits, because taking money out of the corporation will trigger dividend taxes.

“If you’re really not taking the money, you’re not going to have a double tax at all,” said accountant Tom Wheelwright of WealthAbility LLC. “That potential gain down the road can be so big.”

That’s the potential that Mr. Bisges and his nephew are looking for.

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