Choosing the Proper Entity to Acquire a Company

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There are four basic types of entities that may be used to acquire and operate the business of the acquired corporation: (1) C corporations, (2) S corporations, (3) partnerships, either general or limited, and (4) the limited liability company (LLC). The LLC is a hybrid entity authorized in 1988 by the IRS. It offers the legal insulation of a corporation and the preferred tax treatment of a limited partnership. Today, all 50 states and the District of Columbia permit LLC's.

Primary differences exist among the four types of business entities. A regular, or C, corporation is a separate taxpaying entity. Therefore, its earnings are taxed to the corporation when earned and again to its shareholders upon distribution. Partnerships, S corporations, and LLC's, in contrast, are generally not separate taxpaying entities.

The earnings of partnerships and S corporations are taxed directly to the partners or shareholders, whether or not distributed or otherwise made available to such persons. Moreover, partnerships and S corporations may generally distribute their earnings to the equity owners free of tax. Because S corporations, partnerships, and LLC's are generally exempt from tax, but pass the tax liability with respect to such earnings directly through to their owners, these entities are commonly referred to as pass-through entities.

A C corporation is defined in the Internal Revenue Code as any corporation that is not a C corporation. The term C corporation generally excludes corporations granted special tax status under the Code, such as life insurance corporations, regulated investment companies (mutual funds), or corporations qualifying as real estate investment trusts (REITs).

An S corporation is simply a regular corporation that meets certain requirements and elects to be taxed under Subchapter S of the Code. Originally called a "small business corporation", the S corporation was designed to permit small, closely held businesses to be conducted in corporate form, while continuing to be taxed generally as if operated as a partnership or an aggregation of individuals. As it happens, the eligibility requirements under Subchapter S, keyed to the criterion of simplicity, impose no limitation on the actual size of the business enterprise.

Briefly, an S corporation may not (1) have more than 75 shareholders; (2) have as a shareholder any person (other than an estate and a very limited class of trust) who is not an individual, (3) have a nonresident alien as a shareholder, (4) have more than one class of stock, (5) be a member of an affiliated group with other corporations, or (6) be a bank, thrift, insurance company, or certain other types of business entity.

Except under rare circumstances, a partnership for tax purposes must be a bona fide general or limited partnership under applicable state law.

Under most state laws, an LLC may merge with or into a stock corporation, limited partnership, business trust, or another LLC. All members of the LLC must approve the merger unless they agree otherwise. Filing of articles and the effective date operate the same as for corporate mergers.

If practicable, not even a single level of corporate tax should be paid on income generated by the business. For this reason, a pass-through entity owned by individuals should be the structure wherever possible. With respect to an acquisition of assets by individuals, this means that the acquisition vehicle would be either a partnership (presumably limited) or an S corporation. In the case of a stock acquisition by individuals, the acquired corporation generally should be operated as an S corporation.

Where the buyer is a C corporation, the acquired business, 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 distributions from the buyer to its shareholders.

Typically, an S corporation should be considered where the acquired corporation is, or can become, a freestanding domestic operating corporation owned by 75 or fewer U.S. individual shareholders. Because the S corporation requirements are designed to ensure that such entities will have relatively simple structures, they are not inherently user-friendly vehicles for larger, complex operations. Nevertheless, because there is no limit on the size of the business that may be conducted in an S corporation, it is often possible to plan around obstacles to qualification under Subchapter S and to use this favorable tax entity.

The partnership is an alternative to the S corporation, with several notable advantages. First, it is always available without restriction 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. In addition, the partnership is unique in enabling the partners to receive distributions of loan proceeds free of tax. Finally, if the acquired corporation is expected to generate tax losses, a partnership is better suited than an S corporation to pass these losses through to the owners. The last two advantages result from the fact that partners, unlike S corporation shareholders, may generally include liabilities of the partnership in their basis in the partnership.

No matter what entity is formed for the acquisition of a company, it is always important to seek advice from an accountant or tax attorney who is sound in corporate structure prior to formation.