Tax information about corporate entities and strategies

S and C Corporations Create Different Tax Consequences

An S corporation is a pass-through tax entity, while a C corporation is a completely separate taxpayer from its owners.

A savvy business owner must carefully consider both non tax and tax ramifications when deciding how to structure the business. It is unwise to select a business structure based solely upon tax considerations. But, it is also unwise to neglect to consider the tax impact of your decision.

For example, if you run a business that engages in operations that are considered "risky" or subject to frequent lawsuits, your legal advisers are likely to urge you to incorporate or form an LLC. While doing so will complicate your taxes, you would be foolish to put your assets at risk for the sake of a easy-to-prepare tax return.

Non tax considerations that may make incorporation the best choice are

- ease of obtaining investment capital
- increased ability to recapitalize and reorganize the business as it grows larger
- increased latitude in succession planning

In addition, there are tax advantages. Incorporating provides access to tax strategies that aren't available otherwise, such as accumulating income within the corporation or providing income to the shareholders using both salary and distributions. There are some potential disadvantages as well—although with recent tax law changes these are not as discouraging as they were.

For example, income of a regular corporation may be "taxed twice." The income can be taxed on the corporation's own tax return and once again on the shareholder's individual return.

Being aware of double taxation helps you and your tax advise minimize the impact. But, now that the top individual tax rate is 39.6 percent and there is a tax on net investment income, the tax disadvantages are far less than they were a few years ago.

If you decide to incorporate, we recommend that you seek expert advice in setting up a corporation and writing your bylaws.

S Corps and C Corps Are Not Taxed the Same

Any corporation is first formed under the laws of a particular state. From the standpoint of state business law, a corporation is a corporation. However, there are two types of for-profit corporations for federal tax law purposes:

- C corporations: What we normally consider "regular" corporations that are subject to the corporate income tax
- S corporations: Corporations that have filed a special election with the IRS. They are not subject to corporate income tax. Instead, they are treated similarly (but not identically) to partnerships for tax purposes.

Keep in mind, the distinction between a C and an S corporation is purely with regard to the way they are taxed. For business law, compliance requirements, and asset protection purposes, they are identical creatures under state law.

C Corps Pay Their Own Taxes

A regular corporation (also known as a C corporation) is taxed as a separate entity. The corporation must file a Form 1120 each year to report its income and to claim its deductions and credits.

Income earned by a corporation is normally taxed at the corporate level using the corporate income tax rates shown in the table below.

Tax Rates for Corporations		
Taxable Income		
Over	**But Not Over**	**Tax Due**
$0	$50,000	$0 plus 15% on amount over $0
$50,000	$75,000	$7,500 plus 25% on amount over $50,000
$75,000	$100,000	$13,750 plus 34% on amount over $75,000
$100,000	$335,000	$22,250 plus 39% on amount over $100,000
$335,000	$10,000,000	$113,900 plus 34% of

		amount over $335,000
$10,000,000	$15,000,000	$3,400,000 plus 35% of amount over $10,000,000
$15,000,000	$18,333,333	$5,150,000 plus 38% of amount over $15,000,000
$18,333,333	---	35% of amount over $18,333,333

Note: Personal service corporations (those whose employees spend at least 95 percent of their time in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting) are taxed at a flat rate of 35 percent of net profits.

Unlike the income thresholds for individual taxes, the corporate income tax thresholds are not indexed for inflation. They only change when Congress passes corporate tax legislation.

After the corporate income tax is paid on the business income, any distributions made to stockholders are taxed again at the stockholders' tax rates as dividends. Income paid to shareholders as wages are also taxed on the shareholder's personal income tax return.

Because of these two levels of tax, a regular corporation may be a less desirable form of business than the other business entities that pass-through the income and deductions directly to the owners. (For federal tax purposes, pass-through entities are sole proprietorships, partnerships, limited liability companies, and S corporations.)

However, good tax planning can often minimize the impact of double taxation, while leveraging the corporate structure to provide other benefits. Plus, with the top individual rate now higher than the top corporate rate and with the ability of a C corporation to retain earnings rather than passing the entire amount through to the shareholders, a regular corporation may be the best tax-advantaged choice in some cases.

C Corp Status Has Pros and Cons

Before selecting or rejecting the corporation business structure, it's important to consider both the advantages and disadvantages that a corporation has under federal tax law. Too often, small business owners fear incorporating because of the specter of "double taxation." While this can be a consideration, it is certainly not the only consideration and, often, it is not the "deal killer" that business owners imagine.

Salaries May Offset Corporate Income

Not all of the corporate profits will be subject to double taxation.

The operators of the corporation may withdraw reasonable salaries and these salaries are deducted from the corporation's profits. This means that the salaries are not taxed at the corporate level. (Put simply, the issue of double taxation does not exist for salary payments.) In some cases, the entire net profit may be offset by salaries to the owners, so that no corporate income tax is due.

On the other hand, if the corporation pays dividends to the shareholders, those payments are subject to corporate-level income tax. However, the individual does not have to pay self-employment tax on the dividends.And, qualifying dividends (and most United States corporation dividends can fit into this definition) are taxed at capital gains rates and not the individual's top marginal tax rate. Finally, dividends paid to a shareholder that actively participates in the business are not subject to either the 0.9 percent Medicare surtax on earnings or the 3.8 percent tax on net investment income that are levied on higher-income taxpayers.

Warning

If your corporation is profitable but does not pay any dividends for an extended period of time, the IRS is likely to conclude that some of the salaries paid to owners are really disguised dividends. The IRS can disallow some or all of the salary deductions, resulting in a large tax bill plus interest and penalties.

If you have a corporation, your best bet is to make sure all salaries are not significantly higher than industry standards, and to pay out at least some dividends each year.

Corporations Can Accumulate Earnings

Because a corporation is a separate taxable entity from its stockholders, the profits remaining after being taxed at the corporate level are not, as in the case of unincorporated businesses and S corporations, taxed to the owners when they are earned. **The profits are taxed only if and when they are actually distributed to the stockholders as dividends.**

However, a corporation can not retain unlimited amounts of income for unlimited periods of time. Virtually any corporation can accumulate up to $250,000 in retained earnings without becoming subject to tax on the accumulated funds. In addition, as long as the accumulation is related to a reasonable business need, then it will not be subject to tax.

In a business that plans major capital investments or expansions, the ability to accumulate income within the corporation can actually save taxes in the long run.

If the accumulations are not related to the reasonable needs of the business, an accumulated earnings tax of 15 percent will apply in addition to the regular corporate tax.

Example

Anne's "Relax and Revitalize" spa had a profit of $500,000. Anne realizes that she could double her income if she opened another location. However, she doesn't want to expand too quickly and feels waiting a year or two would make more sense.

If Anne operates her business as a sole proprietor, she will need to pay income tax (and self-employment tax) on the $500,000 profit. She must pay tax on this amount even if she puts a significant amount into a saving account to be ready for her expansion in coming years.

However, if she operates her business as a regular (C) corporation, she could retain a significant portion of the profit in her corporation. She wouldn't need to pay tax on the amount on her individual tax return.

Be Careful When Interacting with Your Corporation

Transactions between a closely held corporation and its stockholder-owners will be closely examined by IRS agents. If corporate property is diverted to the stockholders, they will be considered to have received what is called a "constructive" or "preferential" dividend. This tax treatment is highly unfavorable, because this dividend will be taxable to the owners and will not be deductible to the corporation.

The most common type of preferential dividend received by stockholders involves the payment of personal expenses on behalf of stockholders. Typically, the corporation claims deductions for these expenses as business expenses on its income tax return, but where the expenses are clearly personal expenses, the corporation will be denied a deduction and the officer — stockholder will be deemed to have received a taxable dividend.

Stockholders are also considered to have received constructive dividends when:

- corporate property is sold to a stockholder at less than its fair market value
- employee-stockholders are given unreasonably high compensation
- the corporation pays excess rents to shareholders for property leased by the corporation

- the corporation loans the shareholder funds and there is no intention to repay the loan

Corporations Can Be Hit with AMT

Like individuals, corporations can become subject to an Alternative Minimum Tax (AMT) if they have gained the benefit of "too many" tax preference items. For corporations that are subject to AMT, the general rate is 20 percent (the rate is reduced to 15 percent for certain specific items.)

Tip

Most small corporations will be able to avoid the corporate AMT--oftentimes far more readily than high-net-worth individual's can. The corporate AMT will not apply to any corporation if:

- the corporation is in its first year of existence **or** the corporation was treated as a small corporation exempt from AMT for all prior tax years after 1997 *and*
- its average annual gross receipts for the last three years ending before the 2009 tax year did not exceed $7.5 million ($5 million if it only existed for one prior year).

S Corps Are Pass-through Entities

An S corporation is a creature of the federal tax laws. **For all purposes other than federal income tax (and state income tax that recognizes the federal election), an S corporation is treated as a regular corporation.**

A corporation is formed under state law: you must incorporate in a particular state. Once your corporation exists under state law, you can consider whether you want to have it taxed as a S corporation under federal tax law, by making an election using Form 2553, *Election by a Small Business Corporation*.

This election preserves the corporation's limited liability under state law while eliminating corporate-level taxation. This means that income and losses of the S corporation are passed through to shareholders in much the same manner as a partnership passes through such items to partners.

When to make an S Corporation election. You have an option of making an S corporation for the current tax year or for the next tax year. If you want the election to

take effect for the next tax year, you can file Form 2553 at any time during the tax year preceding the tax year it is to take effect.

If you wish to make an election for the current tax year, you have a small window of opportunity. You must file your form 2553, **no more than two months and 15 days after the beginning of the tax year the election is to take effect.** If you miss that window, the election will take effect for the next year (unless you can show reasonable cause for filing to make the deadline.)

For purposes of computing the time to make the election, the two month period begins on the day of the month the tax year begins and ends with the close of the day before the numerically corresponding day of the second calendar month following that month. If there is no corresponding day, use the close of the last day of the calendar month.

Example

Corporation without a prior tax year. Ray starts his computer repair business on January 7. The two month period ends March 6. Fifteen days after that is March 21. To be an S corporation beginning with the first tax year, the corporation must file Form 2553 during the period that begins January 7 and ends March 21. Because the corporation had no prior tax year, an election made before January 7 will not be valid.

Corporation with a prior tax year. Suppose instead, that Ray's computer repair business has been filing Form 1120 as a calendar-year C corporation. Ray wishes to make an S election for its next tax year beginning January 1, 2015. The corporation can file the election at any point during 2014. If it doesn't file the prospective election during 2014, it can file during the two-month and 15 day period in 2015. The two month period ends February 28 (29 in leap years) and 15 days after that is March 15. To be an S corporation beginning with its next tax year, the corporation must file Form 2553 during the period that begins the first day (January 1) of its last year as a C corporation and ends March 15th of the year it wishes to be an S corporation.

Profits and Losses Allocated Based on Stock Ownership

In an S corporation, all profits, losses, and other pass through items are allocated according to each shareholder's proportionate shares of stock. This means that if you own 50 percent of the stock, you must receive 50 percent of the losses, profits, credits, etc.

This is an important distinction between operating as an S corporation and operating as a partnership or limited liability company. In a partnership, the partnership agreement can provide that partners are allocated different percentages (or changing percentages over time) of different tax items. Thus, a partner can be allocated 40 percent of the profits and 60 percent of the losses during the first three years of a business, and 60 percent of the

profits after the third year. A limited liability company (LLC) operating agreement can achieve the same results for its members.

Not Every Corp Can Be an S Corp

While there is no income limitation on S corporation status, restrictions on the number and types of shareholders and the types of stock can make it difficult to operate a large business as an S corporation. In most cases, family-owned business and small businesses generally are not affected by the limitations.

Only a corporation that meets all of the following requirements can make a valid S corporation election.

- The corporation must be a domestic corporation. This means that it must have been created under federal, state, or U.S. territory and it must be taxed as a corporation under local law.
- All shareholders must agree to the election.
- There can only be one class of stock issued by the corporation. However, there can be both voting and nonvoting shares. A difference solely in voting rights does not create a separate class of stock.
- There can not be more than 100 shareholders. However, certain related parties (such as husband and wife) are counted as a single member.
- There can not be any nonresident alien or non-human entity shareholders, unless the shareholder is an estate or trust that is authorized to be an S corporation shareholder under the tax laws. Certain exempt organizations, such as qualified pension, profit-sharing, and stock bonus plans, or charitable organizations will be allowed to be shareholders in an S corporation (for purposes of determining the number of shareholders of an S corporation, a qualified tax-exempt shareholder counts as one shareholder).
- An S corporation can hold qualifying wholly owned subsidiaries and can own 80 percent or more of the stock of a C corporation. The C corporation subsidiary can elect to join in the filing of a consolidated return with its affiliated C corporations, but the S corporation cannot join in the election.