Module 1.5: C Corporations

You will find that most large businesses are created as regular or C corporations. Many of them are household names like IBM, Microsoft, or Amazon. C corporations get their name because they are subject to Subchapter C of the Internal Revenue Code.

Some businesses formed after 1996 are taxed as corporations by default such as:

- A business formed under a federal or state law that refers to it as a corporation, body corporate, or body politic.
- A business formed under a state law that refers to it as a joint-stock company or joint-stock association.
- An insurance company.
- Certain banks.
- A business wholly owned by a state or local government.
- A business specifically required to be taxed as a corporation by the Internal Revenue Code (for example, certain publicly traded partnerships).
- Certain foreign businesses.
- Any other business that elects to be taxed as a corporation.

Very few small businesses set themselves up as C corporations, because of the extra paperwork, restrictions, oversight and taxes involved.   However, it may be advantageous if your goal is to bring in additional investors in the near future to grow your business. It is then just a matter of selling additional stock on the private market or eventually on one of the stock exchanges.

A corporation is an independent legal entity owned by shareholders, with daily management decisions made by managers and executives, and a board of directors to guide the corporation at a high level. Larger businesses usually have separate and distinct shareholders, executives, and directors.   In smaller corporations it is possible to see the owners wear several hats and become shareholder-executives, shareholder-directors, etc. In most states, it is even possible just to have a single person that is simultaneously the 100% shareholder, sole director, and sole executive in a business.

Regardless of whether a corporation is composed of one person or many people, a corporation has many rights that are similar to those of a human being, such as free speech rights, the rights to own land, rights to enter into contracts, and for better or worse, rights to make political donations.

A corporation has its own tax ID#, and is often considered to be, within the legal world, extremely similar to a living breathing human being. Thus, the corporation itself is a legally distinct being and is held legally responsible for the debts and liabilities that are created through the operation of the business - not the individual owners (shareholders) like all other legal business formats.

The corporate ownership is simply represented by shares of stock, and the corporations sell ownership shares through stock offerings.

Corporations are created at the individual state level and are subject to the laws of that state. This involves establishing the corporation's name and registering its legal name with their state government. To register one's business as a corporation, certain documents need to be filed, typically the Articles of Incorporation with the Secretary of State and registering with the corresponding Department of Revenue. (There are only six states that do not have corporate taxes.) Let's look at the different types of corporations that there are:

Forming a Corporation

The formation of a corporation is governed by state law and usually includes the following steps:

- Establish a business name and register it with the state government. The name should include a corporate designation, such as "Incorporated," "Corporation," or "Limited," at the end of the business name. At times, the entity will conduct business under a different name. This alternate name is also known as a trade name or DBA ("doing business as") name.
- File articles of incorporation with the state. These documents establish the existence of the corporation in the state.
- Determine the number of shares of the corporation that will be issued and the number and/or names of the initial board of directors.
- Create bylaws to define the rules and responsibilities of shareholders, directors, and officers.
- Obtain an employer identification number (EIN) from the IRS. This may be completed in minutes at the IRS website as we discussed in module 1.2.

Many states offer sample articles of incorporation and other required documents through the Secretary of State's office. States will generally charge a filing fee for incorporating. An annual report is usually required to verify the corporation's status and if there are any changes in the names of responsible parties, as well as a yearly fee.

Foreign Corporations

The term "foreign corporation" can be correctly applied in two different situations.

- A U.S. corporation that does business in multiple locations may be required to register with each of the states in which business is conducted. The entity is considered a "domestic corporation" in the state in which they are incorporated. In other states where they conduct business, they will not follow the entire incorporation process again, but will register as a "foreign corporation." The tax consequences are similar to an individual taxpayer who files as a resident in their home state and nonresident in another state.
- A corporation that is not based in the United States is also called a foreign corporation.

Personal Service Corporations

A corporation is considered a personal service corporation (PSC) if its principal activity is the performance of personal services, and the services are performed by employee-owners.

- Personal services include activities in the fields of accounting, actuarial science, architecture, consulting, engineering, health, law, and the performing arts.
- An employee-owner is someone who owns any stock in the corporation and also performs personal services for the corporation. The individual may be considered an independent contractor for other purposes and still meet this test. The testing period is generally the prior tax year.

Closely Held Corporations

A corporation that is not a personal service corporation is described as "closely held" if at any time during the last half of the tax year, more than 50% of the value of its outstanding stock is directly or indirectly owned by five or fewer individuals.

The term "individual" for this purpose can also include certain types of trusts and private foundations.

Closely held corporations are subject to special provisions, including at-risk rules and passive activity rules, which may limit losses. These are in place to prevent individuals from using the corporate structure to evade tax obligations. You can find more information about these provisions in Publication 542 at the irs.gov website.

Personal Holding Companies

A corporation is considered a personal holding company (PHC) if it meets both of the following tests:

- *Income test.* At least 60% of the corporation's adjusted ordinary gross income for the tax year is from dividends, interest, rent, royalties, and annuities.
- *Stock ownership test*. At any time during the last half of the year, five or fewer individuals own more than 50% in value of the corporation's outstanding stock.

In addition to paying normal corporation income tax, PHCs are subject to an extra 20% tax on undistributed PHC income, which is calculated on Schedule PH (Form 1120), *U.S. Personal Holding Company (PHC) Tax*. More information can be found in the instructions for Schedule PH (Form 1120).

Financial Statements

The C corporation is an entity completely separate from its owners and pays its own taxes just like individuals do. Like individual taxpayers and other business entities, corporations are required to report income and expenses for the year. However, corporations must also report assets, liabilities, and capital of the business.

Two types of financial statements that are used in the preparation of Form 1120 are the income statement and balance sheet. We will discuss both of these in more depth in module 2.5 and module 3.7.

Paying Dividends

Each year, a corporation has the *option* to distribute its profits as dividends to shareholders. It may carry over on its books any profits for future expenses or expansions or any net operating losses to offset past or future corporate income.

If a company distributes more than its retained earnings and profits, the distribution is considered a non-taxable return of capital, or non-dividend distribution.

A corporation cannot deduct the dividends paid, so:

- The corporation pays tax on their profits on Form 1120.
- Shareholders pay tax again on the dividends on Form 1040.

This means that C corporations are sometimes described as being subject to "double taxation" because their profits are taxed once at the corporate level, and then again at the individual shareholder level.

Note: A corporation that is a shareholder of another corporation may deduct a percentage of dividends

A shareholder claims a profit or loss in the year they sell their stock. If they sell their stock for a loss, the loss is limited to a $3,000 deduction per year, with the rest carried over to the next year until used up.

A century ago, before the creation of our modern day retirement plans like 401ks, IRAs and others, people purchased stock and then reinvested the dividends to buy more stock in corporations throughout their lives. Then they later started receiving the dividends as a means of retirement income.

Types of Stock

There are several different type of stock that your corporation may issue. The most common type is called, of coarse, common stock. It is the typical stock that you can buy through a stock exchange with your broker of choice.

The next is called preferred stock, which very few corporations issue. This is a hybrid security that integrates features of both common stocks and bonds. A preferred stock is a share of a company just like a regular (or common) stock, but preferred stocks include some added protections for shareholders. For example, preferred stockholders get priority over common stockholders when it comes to dividend payments.

Preferred stockholders also rank higher in the company's capital structure (which means they'll be paid out before common shareholders during a liquidation of assets). Thus, preferred stocks are generally considered less risky than common stocks, but more risky than bonds.

Section 1244 Stock

Now, if you business is involved in a more speculative field of endeavor (where losing your investment is greater) it can sometimes be harder to get investors because of the $3,000 a year loss limitations I mentioned earlier. To compensate for this, you may want to consider issuing Section 1244 Stock instead of common or preferred.

If both the shareholders and the corporation qualify, it may be advantageous for a new corporation to issue Section 1244 small business stock at its inception. This can be important in attracting initial investors, because if the new business should fail, the investor is not limited to the $3,000 a year capital loss deduction.

An individual can claim a Section 1244 stock loss as an ordinary loss of up to $50,000 as a single taxpayer or $100,000 when filing as married filing jointly. Ordinary loss can be subtracted directly from other earned income (such as salaries) that the taxpayer may have. Any remaining loss is treated as capital loss, reported on Schedule D and subject to the $3,000 year limit.

In order to qualify for Section 1244 stock:

1. The stock must be issued when the corporation was a small business corporation, which is defined as money and other property received for stock, contributions to capital, or paid-in surplus does not exceed $1 million. Any contributed property is valued on the adjusted basis reduced by any liability it was subject to at the time it was contributed.

2. The stock can only be issued to the original investors to the corporation. If the stock is sold, given as a gift, or transferred to a trust or estate, it loses its Section 1244 status.

3. The corporation cannot derive more than 50 percent of its gross receipts from certain sources, such as royalties, rents, dividend, interest, annuities, and stock or security sales. These are all investment income profits.

The testing period for the above qualifications is the five taxable years immediately preceding the year in which the loss was sustained. That means, for instance, if you have been in business for 10 years, then to take the loss as ordinary income, the business must have met these three qualifications for the last five of those ten years. For corporations in business less than five years, the testing period is all the corporation's taxable years before the year in which the loss took place.

Employees

As with other legal formats, a corporation must have each employee fill out IRS Form I-9, *Employment Eligibility and Identity Verification,* and Form W-4, *Employee's Withholding Allowance Certificate*, then withhold income from each employee's salary based on the exemptions claimed.

The corporation must also withhold the employee's part of FICA (Social Security/Medicare), as well as pay the employer's share of social security/medicare taxes (FICA), federal unemployment taxes (FUTA), state unemployment taxes (SUTA), and worker's compensation premiums. All these must be remitted at the appropriate times to the appropriate federal or state government agencies.

Small corporations normally employ shareholder-owners, which are typically the founders. One way to prevent double taxation is for the owners to pay themselves a salary which, if reasonable, can be used as a deductible expense to the corporation. Reasonable compensation is defined as an amount that would ordinarily be paid for similar services for similar corporations under similar circumstances. Otherwise, what you would pay someone else to do your job.

The IRS can disallow the deduction if the compensation is unreasonable as they view this as a tax avoidance scheme. At the same time, the recipient of the unreasonable income will still have to pay taxes on the full amount received even though the deduction is disallowed.

This means that you can't pay yourself 100% of the profits so the corporation has no profits left to pay dividends on. That is considered evasion of taxes, because you are trying to get around the double taxation of the C corporation rules.

Finally, let talk about fringe benefits differences.

It used to be that if you wanted to give yourself tax-advantaged fringe benefits, the best way to do that was through the use of a C corporation. However, over the last two decades the government has gradually increased the amount of benefit deductions that can be taken by other legal formats.

For instance, for businesses that pass-though taxation (all other formats) you used to be able to only deduct 30% of what you paid in health insurance premiums as an adjustment to income, but a C corporation could deduct 100% of the cost they paid. But today, every business format can deduct 100%. There have also been upgrades on the deductibility of some types of retirement plan premiums.

So one final factor you need to take into consideration when choosing which legal format to choose is what kind of perks do you want your corporation is pay to it's employees - including you. Are they the kind that only a C corporation can provide, an S-corporation can provide or any of the business formats. The C corporation has the largest amount of fringe benefits that can be deducted at the corporate level.

Plan not only for today, but your future as well. You will find a complete discussion on fringe benefits in the bonus section of the course.

Let's review the pros and cons:

The Pros:

- No liability for non-active stockholders.
- No restrictions on ownership.
- Ownership can simply be transferred through the sale of stock.
- A completely separate entity from stockholders.
- Better fringe benefits for owner-officers than other formats.
- Can have ownership interest in any other type of business entity.
- Perpetual existence until closed.

- Raising capital can easily be achieved by issuing stock.

The Cons:

- Double taxation of profits.
- Complex and expensive to create and maintain.
- Requires regular board of directors' meetings and minutes.
- Requires a separate tax return.

As I said earlier, for most small business people the C corporation is probably not the best solution unless you plan to attract investors to your venture. For most, the S corporation election offers a much easier and tax advantaged solution.

And don't forget to check out the Bonus section for a list of the state websites for the Secretary of State's and Department of Revenue's corporate information!

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