

Module 3.7: C Corporation Taxation

Separate Taxable Entity

A C corporation is an entity completely separate from its owners. It will pay taxes on its profits at the entity level and contrasts with the treatment of many other business entities. Other common types of business entities are not taxed on their own returns:

- Sole proprietors will file Schedule C, Form 1040, to report profit or loss from business activities. Profits of a sole proprietor are taxed on the business owner's Form 1040.
- Subchapter S corporations filing Form 1120S and partnerships filing Form 1065 are pass-through entities. Profits from these businesses are **not** taxed on the entity returns, but instead are passed through to the individual shareholder or partner using the appropriate Schedule K-1.

It is not my intention in this module to teach you how to do a corporate return. What I do want to point out are all of the things you need to know to make good decisions running your business and protect your profits from overpaying corporate taxes.

Financial Statements

Corporations, like individual taxpayers and other business entities, are required to report income and expenses for the year. However, C corporations have the added requirement to report assets, liabilities, and capital of the business.

To accomplish this, two types of financial statements that are used in the preparation of Form 1120: the income statement and the balance sheet. While we discussed these in module 2.5, let's briefly review them again.

Income Statements

A corporation's income statement (also referred to as a profit & loss statement) reflects financial activity over a specific time period, which is usually the corporation's tax year. It shows the company's profitability. The formula underlying the income statement is:

$$\text{revenue} - \text{expenses} = \text{net income (net loss)}$$

The income statement consists of two major categories: revenue and expenses:

- Revenue is the amount earned during the period of the income statement.
- Expenses are the costs the company spends to generate revenue. Expenses may include operating expenses and non-operating expenses.

As you learned previously, if the taxpayer uses the cash basis of accounting, revenue is recorded when the funds are received, even if the service has not yet been provided or the product has not been delivered to the buyer. Expenses are generally deducted or capitalized in the tax year in which they are paid.

And if the taxpayer uses the accrual method of accounting, revenue is recorded when the service is provided, or the product is sold, even if cash is not received yet. Expenses are deducted or capitalized in the year incurred.

Balance Sheets

A corporation's balance sheet reflects the assets, liabilities, and capital of the business. It is a snapshot of its financial position at a specific point in time.

The formula underlying the balance sheet is:

$$\text{assets} = \text{liabilities} + \text{owner's equity}$$

The two sides of the balance sheet must equal. To complete the tax return, you will need balance sheet information from the beginning and end of the tax year.

- Assets are listed in order of liquidity, which is how quickly an item can be converted into cash, which is why cash is listed first.
- Liabilities are the amount the company owes to outside parties. This includes bills to suppliers and loans to creditors.
- Equity is the money that shareholders have invested in the business. The term "net assets" can also be used, because it is the assets of the business minus its liabilities. Equity includes shares of stock in the corporation, other paid-in capital, and retained earnings. Retained earnings are the accumulated net earnings or profit of a company that have not been distributed to shareholders.

How To Withdraw Profits from Your Business

As we've discussed, taxpayers who own their businesses should keep the assets of the business separate from their personal assets. While this is a strong suggestion for sole proprietors filing Schedule C, it is absolutely critical for corporate shareholders.

Unfortunately, many small business owners treat their corporations as personal checkbooks, using corporate assets to pay for personal expenses. This practice can jeopardize the corporation's legal status.

There are a four main legal ways for business owners to withdraw funds from their C corporation.

1. Wages:

A shareholder who performs services for the corporation may receive reasonable wages, including salary and bonuses just like any other employee. Of course, payroll taxes must be paid on these amounts. Compensation expenses are deductible by the corporation and reported as ordinary income by the shareholder from their W-2. Remember: If an IRS auditor determines that the wages are unreasonable, they can assess a penalty.

2. Dividends:

This is the simplest way for cash to be paid to a shareholder. However, since the amount distributed is not a deductible expense for the corporation, it is effectively taxed twice, once at the entity level and again at the individual shareholder level.

3. Fringe Benefits:

Employee benefits, including life, health, and disability insurance, may be paid by the corporation on behalf of the owner who is also an employee, if the plan also benefits other employees. These benefits may be deductible to the corporation and tax-free to the employee with an IRS approved plan. (See our Fringe Benefits article in the Bonus section for a comprehensive discussion on fringe benefits.)

4. Loans:

A corporation may lend money to a shareholder. The loan should be structured as if it were an arm's length transaction, including a repayment schedule and reasonable interest rate. Arm's length transactions are structured the same way you would borrow the money from a bank.

Business Expense Reimbursement:

If the shareholder spent personal funds on expenses of the business, they may be reimbursed according to the company's expense reimbursement policy. There are accountable plans and non-accountable plans and they both have their own set of rules. I am not going to go into all the rules here, but let me explain the difference.

Under accountable plans, your employees - including yourself - turn in the receipts and/or mileage logs to the corporation and the corporation reimburses the exact amount that was spent. This can be weekly, bi-weekly, or months depending on the corporation's accounting methods.

Under non-accountable plans, your employees get a set amount per period, usually monthly, to spend on business expenses. They do not have to turn in the receipts and/logs. If they spend

more than the amount allotted, it comes out of their own pocket. If they spend less, they get to keep it.

From what I've seen, the majority of business use accountable plans to keep better control of expenses.

The Corporate Veil

I wanted to take a minute to discuss why the things we are talking about here are so important. One of the reasons people create C corporations is because they are a completely separate entity and therefore, they believe, their personal assets can't be touched.

However, in rare circumstances, the limited liability aspects of a corporation can be set aside, and the shareholders of a corporation may be held personally liable for the corporation's actions and debts. This is called "piercing the corporate veil." The precise requirements for when this is permitted vary by state.

Please realize that the failure to maintain separate books and records, or commingling personal and corporate funds, increases the risk that a veil-piercing action will be allowed. Although the details of piercing the corporate veil are beyond the scope of this course, the fact that such actions exist highlights the critical importance of maintaining corporate books and records separately from any individual shareholders' accounts. This is also true of S corporations and LLCs.

Accumulated Earnings Tax

So what if a corporation just decides to keep its profits and not distribute them? Well, the IRS has rules for that also! If a corporation does not distribute enough profit to shareholders, earnings may build up beyond the reasonable needs of the business.

In this case, corporations are subject to an *accumulated earnings tax* on the undistributed excess. This tax is intended to encourage corporations to issue dividends to shareholders. After all, the IRS wants their dividend taxes.

The IRS considers an accumulation of \$250,000 or less (\$150,000 or less for personal service corporations) to meet the "reasonable needs" of most businesses. Now, this is not something most small corporations need to worry about, but I want you to be aware of this when you get to be that successful.

A corporation has "reasonable needs" to keep additional cash on hand if it has specific, financially feasible plans for the additional earnings, for example, a planned expansion of the business. A company should be prepared to document this need and show that the earnings were not accumulated so the shareholders could avoid paying income tax on dividends.

"Reasonable need" may also apply if the corporation keeps enough cash on hand to redeem stock that is included in the gross estate of a deceased shareholder.

Corporations should *never* voluntarily pay the accumulated earnings tax. The IRS will review the return and other information provided by the corporation and assess the tax if applicable. The tax is assessed at 20% of the excess accumulation, plus interest from the due date of the return, without extensions.

Not all corporations are not subject to the accumulated earnings tax. You don't have to worry if you are:

- S corporations
- Personal holding companies
- Tax-exempt organizations
- Passive foreign investment companies
- Foreign personal holding companies

Corporate Losses

A corporation may have deductible expenses that exceed its income and have a loss for the year. This creates a net operating loss (NOL) that may be carried to future tax years and used to offset future net profits.

Special rules apply to losses of insurance companies and farming losses, but corporations are prohibited from carrying their NOLs back to prior years anymore. In other words, losses could only be carried forward to future tax years. The NOL deduction is also limited on a future return to 80% of taxable income. The loss is carried forward until it is all used.

Form 1120

All domestic corporations (except tax-exempt organizations) are required to file Form 1120 and must do so each year the corporation exists, whether or not they have taxable income. We are going to only do an overview of Form 1120 and its filing requirements so you understand the structure.

Form 1120 is generally due by the 15th day of the fourth month after the end of its tax year, or April 15 for calendar-year corporations. Corporations may request an extension of time to file using *Form 7004, Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns*. The extension period is six months.

Remember that filing Form 7004 extends the time to file the tax return but does not extend the time to pay tax. You are required to send what you estimate you taxes will be for the tax year

with the extension. This amount is then adjusted when the return is filed, with the remainder of the tax submitted or a request for refund if you sent too much with your extension.

A C corporation using a fiscal year ending on June 30 must file by the 15th day of the **third** month after the end of its tax year. However, the corporation will be eligible for a seven-month extension of time to file, instead of six.

How to File Your Return

Corporations may file Form 1120 electronically or by mail. Penalties may be imposed for late-filing and late-payment. What is interesting is the fact the penalty for not filing on time is ten times more than the penalty for not paying on time. So, even if you don't have the money to pay, always file the Form 1120 on time to avoid the penalties.

In addition, there may be penalties applied for negligence, fraud, substantial understatement of liabilities, and other circumstances and they can be substantial - *very substantial*.

Corporations are required to file Form 1120 *electronically* if both of the following conditions are met:

- The corporation has total assets of \$10,000,000 or more.
- The corporation files at least 250 returns a year. This includes information returns such as Form W-2 and Form 1099-MISC.

If you can't electronically file for some reason, waivers may be requested to the e-file requirement. Waivers normally will be granted in the following four situations:

- Catastrophic events. If a taxpayer suffers a catastrophic event and continues to be affected by the catastrophe after any IRS disaster or emergency relief has passed, they may be granted a waiver.
- Substituted return process. When a taxpayer has a business need that will require them to file a second return prior to the extended due date, they should request a waiver. Generally, they will file the first return on paper and the second "substituted" return electronically.
- Chapter 7 bankruptcy. The taxpayer has filed a petition for Chapter 7 bankruptcy.
- Final/Last return required. A waiver will generally be granted if the taxpayer is filing their final return.

The IRS will not usually grant waivers because of software limitations of the tax preparation software used by the taxpayer. Blaming the software just won't work in this case.

How to Pay Your Taxes

A corporation is required to make estimated tax payments if it expects its tax liability to be \$500 or more. Installments are due on the 15th day of the 4th, 6th, 9th, and 12th months of the tax year. For a calendar tax year that would be April 15th, June 15th, September 15th, and December 15th.

Unlike other legal formats, corporations *must use* electronic funds transfers to make all federal tax deposits. This includes payroll taxes, estimated tax, and the taxes due with Form 1120. Most companies use the Electronic Federal Tax Payment System (EFTPS). More information on EFTPS can be found at eftps.gov.

If a corporation does not want to use EFTPS, it may make arrangements for a trusted third party to make deposits on its behalf. Alternatively, the corporation may have its financial institution make a wire payment on its behalf and many smaller corporations do this.

Deductions

Not all expenses of a corporation are fully deductible. Certain items are nondeductible or subject to limits. You should know this so you don't end up not being able to deduct your hard earned money.

- **Compensation of officers**

Corporations deducting officers' compensation must attach Form 1125-E to their return if the corporation's total receipts are \$500,000 or more.

For publicly-traded corporations, there is a \$1,000,000 limit on the amount of deductible compensation of "covered employees", which are the chief executive officer (CEO), chief financial officer (CFO), and the three other most highly paid executives of a corporation.

Also, amounts paid under "golden parachute" payments to certain individuals may not be deductible in full. A golden parachute payment is made when a corporation agrees to pay certain executives an amount beyond their normal compensation if control of the company changes hands. If you encounter a corporation that makes golden parachute payments or pays any officer more than \$1,000,000, further research on this Section 162(m) limit is recommended.

The deductible amount of officer compensation does not include the amount attributed to cost of goods sold (COGS), elective contributions to deferred accounts such as 401(k)s, or amounts deducted elsewhere on the return.

- **Business interest paid**

For large businesses (with average annual gross receipts that exceed \$26,000,000), the

deduction for business interest paid is limited to 50% of adjusted taxable income. This limitation is calculated using [Form 8990, Limitation on Business Interest Expense Under Section 163\(j\)](#).

- **Charitable contributions**

A corporation may not deduct more than 10% of taxable income. The CARES Act allows a corporation, for tax years 2020 and 2021, to increase the 10% to 25% of taxable income. Contributions over the 25% limitation cannot be deducted for the tax year but can be carried over to the next 5 tax years.

- **Meals and entertainment expenses**

The Tax Cuts and Jobs Act (TCJA) eliminates the deduction for business entertainment expenses., but the 50% of the cost of business meals is still deductible. However, the Consolidated Appropriations Act of 2021, increased the business-meal deduction for the cost of food and beverages provided by a restaurant from 50 percent to 100 percent in 2021 and 2022 of their food or beverage expenses provided by a restaurants as long as the business owner (or an employee of the business) is present when food or beverages are provided and the expense is not lavish or extravagant under the circumstances.

- **Dividends Received**

To reduce the impact of double taxation of dividends, the Tax Code allows corporations a special partial deduction for dividends received from other corporations. The deduction amount depends on the corporation's ownership stake in the other corporation.

Foreign Dividends Received

A 100% deduction is available for certain foreign-source dividends received by U.S. corporations that are shareholders in foreign organizations.

Beginning in 2018, a U.S. shareholder that is a C corporation and owns 10% or more of a foreign corporation may deduct 100% of the distributed earnings received from its foreign subsidiaries. The effect of this deduction is that U.S. corporations are taxed only on income earned in the United States (with some exceptions).

Tax Rates

The current tax rate for all corporations, including personal service corporations, to a flat 21% rate.

C corporations do not receive favorable tax treatment for long-term capital gains as pass-

through entities do. These are taxed at the same rate as other income. It should be noted that capital losses are allowed, but only to the extent that they offset capital gains.

Tax Implications of Buying and Selling Shares

Finally, let's discuss corporate stock. The initial shareholders normally contribute cash or property to the corporation in exchange for shares in the corporation. The corporation doesn't usually recognize gain or loss when issuing shares and the shareholder doesn't recognize gain or loss when shares are purchased with cash.

There are special rules when obtaining stock by contributing property to the corporation. In this case, while a taxpayer is usually required to recognize gain or loss upon the sale or exchange of property - there is an exception for acquiring stock. This exception is provided for in Code Section 351. But, the following factors must be present to apply this exception:

- The property must be transferred to the corporation solely in exchange for stock,
- The stock purchasers must control the corporation immediately after the exchange,
- The exchange must have a valid business purpose; and
- The corporation must not be an investment company.

Another way that people often obtain stock in small corporations is to assign shares in exchange for services to the corporation. This transfer of services is not considered a transfer of property for tax free exchanges.

If a stockholder receives stock in exchange for services provided to the corporation, that stockholder must claim the stock as income based on the fair market value (FMV) of the stock received. The same concept takes place in partnerships, whereas in partnerships the service provided is valued at the FMV of the service provided. In corporations, the service is valued at whatever the value of the stock received is. Either way, it is taxable income to the person providing the services.

Final Thoughts

At I said at the beginning, my aim here was not to teach you how to be a tax preparer. What I hope I have provided is the knowledge - along with the modules previous to this one - that you need to make the decisions to properly operate your corporation. Tax laws change from year to year as the winds of politics change direction, but most of these concepts have been in place for many years with minor changes. See you in the next module.