C Corporation Guide

Learn if the benefits of a C Corp will outweigh the costs.

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Your Guide to C Corporations

Why do they call it a C Corporation?

Why not an A Corporation or just a corporation? Like many other sources of confusion, taxation is to blame. Back in the day there was just one form of corporation. It was called, as anyone would suspect, a corporation. Then in 1958, President Eisenhower and Congress saw the need for a hybrid entity – one that combined the limited liability of a corporation with the flow through taxation of an unprotected partnership. This was a major change. (The similar LLC didn't come forward until 1977.)

The question became how do we distinguish between the old format and the new one. They are both corporations. Without much thought or creativity they looked to the tax code. The new hybrid entity was allowed under sub chapter S of the code. So they called it an S Corporation. The regular old corporation was authorized under section C. So they called it a C Corporation. While I wish the story was more interesting this is really how we got to C Corporations and S Corporations.

You have heard people talk about C Corporations. Some people swear by them, others at them. What are C Corporations? What are some advantages and disadvantages of using one?

C Corporations are the oldest and one of the most common formal business entities in the United States. There are many major advantages of conducting business in the form of a C Corporation, as well as some disadvantages, which this guide will illustrate.

C Corp Advantages

Limited Liability/Liability Protection for Owners

A C Corporation is an entirely separate and independent legal entity from its owners (or shareholders) and there is a separation between ownership and management. As such, the management and shareholders of a C Corporation generally are protected from personal liability for the C Corporation's liabilities and obligations. Although shareholders of a C Corporation may be liable for the amount they have invested in the C Corporation, their own personal assets usually are protected. This limited liability feature also applies to directors, officers, and employees of a C Corporation.

There is one chink in the asset protection of a C (or S) Corporation. If you own shares in a corporation and are sued personally (i.e. after a car wreck) a judgment creditor can reach your shares in the corporation. If you are the majority owner the attacker now controls your business by virtue of share control. Nevada is the only state that extends charging order protection (as in an LLC) to corporate shares.

No Shareholder Limit/Unlimited Number of Shareholders

A big advantage of conducting business in the form of a C Corporation is that there is no limit to the number of shareholders. Likewise, there are no restrictions placed on who can hold shares, and there can be several different classes of shares (think preferred vs. common). By contrast, in an S Corporation, you can only have one class of stock held by up to 100 shareholders, all of whom must generally be individuals residing in the USA. A C Corporation can have thousands of shareholders who can be individuals, corporations, irrevocable trusts, foreign aliens, Martians, whatever. With Nevada and Wyoming C Corporations, officers and directors can reside anywhere in the world. So, if you plan on starting a large corporation with many shareholders, a C Corporation may be a good choice for you. If you are going to be a publicly traded corporation, for example, listed on the New York or NASDAQ stock exchange, it is the method of choice.

Perpetual Existence or Continuance of Existence

Many business entities, including sole proprietorships, are tied to the lives of their owners. When the owner passes, so does the business. However, C Corporations are not so restricted. They are independent of their owners, and they can continue in existence long after the deaths of their owners.

Well-Established Legal Precedents

One less obvious advantage of C Corporations is that the legal precedents surrounding C Corporations are well-established. There are over 200 years of case law defining the rights, features and benefits of the C Corporation. Some investors find comfort in certainty.

Significant Growth Potential

Since C Corporations are able to sell an almost unlimited number of shares to investors (subject to market forces), there is a significant element of growth potential. However, once a C Corporation has acquired more than $10 million in assets and over 500 shareholders, it is required to register with the U.S. Securities and Exchange Commission (SEC).

Who should use a C Corp?

C Corps are great for a business that sells products, has a storefront and employees, and may or may not have a warehouse where it keeps its inventory.

Who should avoid them?

C Corps don't work well with businesses that want to hold appreciating assets, such as real estate, because of the tax treatment on the sale of these assets.

Raising Venture Capital & Attracting Investors

It is easier for C Corporations to raise venture capital and attract investors in their business than it is for the other entity choices. A sole proprietor is limited to one owner. By definition, you can't bring other investors in. A general partnership puts all investors at risk. An S Corporation can only have 100 owners. An LLC restricts the easy transfer of ownership interests.

The C Corporation exceeds all of these limitations. In addition, C Corporations are one of the most widely recognized forms of business, and consequently they often enjoy enhanced credibility and widespread acceptance among venture capitalists and other investors. C Corporations also tend to attract the best employees, because they can offer valuable employee fringe benefits and stock options, which may be very attractive to potential key employees.

The Tax Advantages of C Corporations

Widest Range of Deductions and Expenses

C Corporations enjoy the widest range of deductions and expenses that currently are permitted by the Internal Revenue Service (IRS). This is not generally the case with other forms of business entities.

Managing Real Estate as a C Corp

In a real estate setting many clients will hold title to property in an LLC. One or more asset holding LLCs will then pay the owner's C Corporation to manage the properties. The C Corporation takes in management fees from one or more LLCs and uses that revenue to pay for the owner's healthcare costs and other legitimate deductions. The C Corporation management company is a popular strategy. (Just make sure that the C Corporation doesn't actually own the real estate. Do NOT take title to real estate in a C Corporation. The tax consequences upon a sale are horrific when compared to an LLC or LP.)

Employee Fringe Benefits

C Corporations are able to deduct fringe benefits (like healthcare insurance) from their taxes as a business expenses; meanwhile, shareholders and employees are exempt from paying taxes on the fringe benefits they receive from C Corporations. This is a win-win situation. However, in order to qualify, C Corporations usually must provide these fringe benefits to 70 percent of their employees, and not just to their shareholders. Know that with an S Corporation, the company can deduct health insurance expenses but that if you own more than 2% of the company's stock that premium shows up as income on your personal return. If healthcare is an issue, a C Corporation can be your best choice.

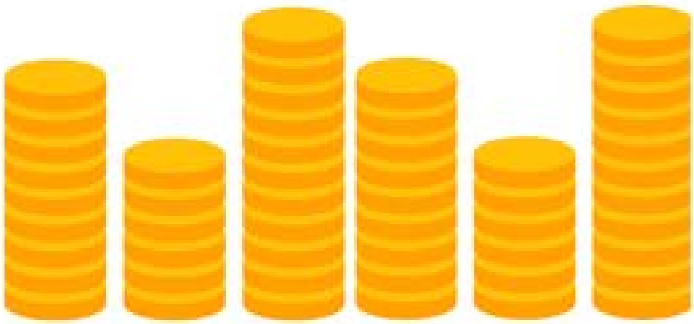
Section 1244 Stock

Again, the "creative" types named this benefit after the code section allowing it.

Normally, losses from the sale of shares are treated as capital losses, which have a lower tax rate than ordinary losses. When you write off losses you want to do it against the highest tax rate you can. By qualifying for Section 1244 treatment, losses up to a maximum of $50,000 for individuals and $100,000 for joint returns can be deducted against ordinary income.

For purposes of comparison (and subject to future changes) generally the tax rate on capital gains is 20% and for ordinary income the highest rate is close to 40%. So you can double your tax write off using Section 1244 to get ordinary income losses.

To qualify, the corporation's aggregate capital must not be higher than $1 million when the stock was issued. The corporation can't derive more than 50% of its income from passive investments. Work with your CPA when using this benefit.



Lower Tax Rate on First $50,000 of Business Income

One of the advantages of C Corporations is that the tax rate on the first $50,000 of business income is only 15%. You have a $50,000 profit and your federal tax is only $7,500. The rest can stay in the company tax free for future growth.

C Corp Disadvantages

Double Taxation

C Corporations are required to pay tax on their profits. If those profits later are distributed as dividends to the shareholders of C Corporations, then the shareholders are also required to pay tax on their dividends. This form of "double taxation" generally is thought to be the single biggest disadvantage of C Corporations. However, with a good CPA on your team, money can be withdrawn in the form of benefits, loans, expenses, leases and by other means, so the threat of "double taxation" can be minimized. That said, S Corporation taxation may be superior for some small business owners. Be sure to work with a professional when selecting your form of corporate taxation.

Corporate Formalities

The operation of a C Corporation does require the initial preparation of some paperwork, such as articles of incorporation and bylaws, as well as the annual formalities of shareholder meetings, board of directors meetings, and the keeping of corporate minutes. But corporate formalities are required for S Corporations and LLCs too. If you want to be protected you have to stay current with all entities.

Strategies for Avoiding Double Taxation

- Structure the C Corp so that there are no profits left over – use all of the write-offs and deductions allowed by the IRS to reduce the C Corp's net income.
- Offer great benefit plans!
- Pay higher salaries to yourself and the other owner/ employees than you would if you were using a flow-through entity such as an S Corp. Yes, you will have to pay payroll taxes and personal income taxes on those monies, but you would pay personal taxes on dividends paid to you anyway. And it may be that in the big picture, the savings on one side outweigh the additional taxes paid on the other side.

Be sure to consult your CPA before implementing one of the above strategies.

Personal Service Company

C Corps can be defined as a personal service company, which has a higher tax rate. A personal service company is defined as any company where substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. Further, a personal service company is a corporation whereby personal services are substantially performed by employee-owners. An employee-owner is any employee who owns more than 10 percent of the outstanding stock of the corporation.

The corporate tax rate for a personal service company is a flat 35 percent, without a graduation of tax rates as in a regular corporation. The purpose is to prevent people who perform personal services from claiming lower corporate tax rates than they would ordinarily have to pay as an individual. Again, work with a CPA to avoid this problem.

Personal Holding Company

A corporation is a personal holding company when (1) at any time during the last half of the tax year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals, and (2) at least 60 percent of adjusted ordinary gross income for the tax year is personal holding company income.

Personal holding company income consists of passive types of income: interest, dividends, royalties, and rents. The kind of income we all like to have because you do not have to work every day to earn it. There are extremely complicated rules associated with personal holding company income, so see your accountant. What you need to know here is that if you do not distribute the income from a personal holding company to yourself, the corporation can be assessed with a 15 percent tax (at this writing) on top of its normal tax rate. Again, the purpose is to ensure that taxes are paid on this income as if the individual had to pay it at individual rates.

No Deduction of Corporate Losses

Unlike S Corporations and LLCs taxed as partnerships, there are no personal deductions of corporate losses within a C Corporation. Shareholders of C Corporations are unable to deduct any corporate losses on their own personal income tax returns. Instead, if a C Corporation loses money in year one, that loss is offset by gains in the future years.

Accumulated Earnings

Every C Corporation with accumulated earnings greater than $250,000 (or $150,000 for personal service companies) is at risk of being taxed an additional 39.6 percent on top of regular corporate tax rates. Accumulated earnings are past profits, the previously taxed income reduced by any capital gain, within a C Corporation. They are the retained earnings held by the corporation without any capital gains reflected and the monies that the company needs for the future to operate and expand its business. The problem is that the IRS likes to see those profits distributed to shareholders, where they can tax them again. They do not want you using them for such mundane and prudent needs as working capital or retaining them as a reserve in case of an economic downturn.

As one would suspect, this is a greatly litigated issue. Courts have generally supported business owners who claim that retained earnings are needed for future expansion, additional inventory, and other legitimate business needs, but beware of this provision. If it becomes an issue for you, consult your tax professional.

The pros and cons of the C Corporation are factors in your choice of entity. Is an S corporation or an LLC better for you? It is best to review such matters with a knowledgable source.

Receive a free 15-minute consultation with an incorporating specialist to discuss these important issues.

Book a time at:
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