

March 16, 2000

# "C" vs. "S" Corporations

<b>1.</b>	<b>INCORPORATION'S ADVANTAGE.....</b>	<b>1</b>
<b>2.</b>	<b>"C." .....</b>	<b>1</b>
	<b>2.1. Advantages.....</b>	<b>1</b>
	2.1.1. Accumulate At Lower Corp Rates.....	1
	2.1.2. ESOPs.....	1
	2.1.3. Misc. Advantages.....	2
	<b>2.2. Disadvantages.....</b>	<b>2</b>
	2.2.1. Unreasonable Comp Attacks.....	2
	2.2.2. Disallowed Corp Expenses Are Dividends.....	3
	2.2.3. 2nd Tax.....	3
	2.2.4. Accumulated Earnings Tax ("AET").....	4
<b>3.</b>	<b>"S." .....</b>	<b>4</b>
	<b>3.1. Advantages.....</b>	<b>4</b>
	3.1.1. No Unreasonable Comp.....	5
	3.1.2. Minimize Medicare Tax.....	5
	3.1.3. Disallowed Expenses: No 2nd Tax.....	5
	3.1.4. Shareholders Use Business' Losses.....	5
	3.1.5. Passive Activities.....	6
	3.1.6. Asset Sale.....	6
	<b>3.2. Disadvantages.....</b>	<b>6</b>
	3.2.1. No Lower Corp Rates.....	6
	3.2.2. California's 1.5% "S" Tax.....	6
	3.2.3. No Pension Borrowing.....	6
	3.2.4. Shareholders Restrictions.....	6
	3.2.5. Fringe Benefits Unavailable.....	7
	3.2.6. Limited Fiscal Years.....	7
<b>4.</b>	<b>PROFESSIONAL/LOAN-OUT PROBLEMS.....</b>	<b>7</b>
	4.1. Corps Subject To These Rules.....	7
	4.2. No Lower Tax Brackets.....	8
	4.3. Conclusions.....	8
<b>5.</b>	<b>CPA'S ROLE.....</b>	<b>8</b>

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## 1. INCORPORATION'S ADVANTAGE.

The principal advantage is limiting your personal liability to the business's creditors. For more detail, read our "Piercing The Corporate Veil" handout.

## 2. "C."

### 2.1. Advantages.

#### 2.1.1. Accumulate At Lower Corp Rates.

##### 2.1.1.1. Bottom Brackets.

"C" corps can keep up to \$75K/yr. at Federal tax rates lower than individuals pay. Important if funds are needed to operate and/or expand. The first \$50K/year is taxed at 15%, and another \$25K/year at 25%: for \$75K/year the tax is \$13,750 or 18.3% (versus the 39.6% individual owner's likely bracket).

##### 2.1.1.2. Top Brackets.

A rate differential favors "C" corps at the top brackets also. The top "C" rate is only 35% Federal, versus a top personal tax rate of 39.6%.

### 2.1.2. ESOPs.

Only a "C" corp can sponsor an ESOP

#### 2.1.2.1. Deduct Principal Repayments.

An ESOP is a way to inject capital into the business on a tax deductible basis. Normally, when a corp borrows money, the repayment of **principal** is **non-deductible**. If the ESOP borrowing from a bank through an ESOP, a non-deductible repayment of principal is converted to a *deductible* ESOP contribution.

### **2.1.2.2. Defer (Perhaps Forever) Tax On Gain From Sale.**

ESOP: excellent exit strategy for the owner.

Owner sells zero (or low) basis stock to ESOP, reinvests proceeds within 12 months in the stock or bonds of some active U.S. corp. Gain is not taxed until the acquired security is sold. §1042.

If, for example, the acquired securities are 40 year bonds, the owner might be dead when the bonds are redeemed. They will "step up" to the date of death fair market value. Deferral becomes **complete income tax avoidance**.

### **2.1.3. Misc. Advantages.**

- 2.1.3.1.** Deductible **uninsured** med. expense plans. §105(h).
- 2.1.3.2.** Deductible medical insurance premiums.
- 2.1.3.3.** Ability to borrow from pension/profit sharing plans.
- 2.1.3.4.** Fiscal year other than calendar (with exceptions).
- 2.1.3.5.** Multiple classes of stock with different rights.
- 2.1.3.6.** Audit advantage (?): items appear on small "C" return rather than the owner's larger return.

## **2.2. Disadvantages.**

### **2.2.1. Unreasonable Comp Attacks.**

IRS wants "C" corps to pay dividends (not deductible). Dividends cause taxes for both the corp and shareholders.

By contrast, the corp can deduct compensation ("comp") paid to a shareholder-employee. So comp is taxed only once. That difference entices owners to pay themselves more comp and little - or no - dividends.

Assume IRS says dividends should have been paid. It reclassifies some of the

shareholder-employee's comp as a dividend: it was "unreasonable" (too high). The taxpayer can contest that finding in Tax Court. Otherwise, that reclassification requires the payment of back corp taxes, interest and penalties.

### **2.2.2. Disallowed Corp Expenses Are Dividends.**

This is closely related to the unreasonable comp problem.

**Example:** your corp deducts expenses, e.g., meals & travel. IRS says the expenses are unrelated to the business. You can, of course, argue with the IRS and even take the case to Tax Court. Otherwise, the expenses will be reclassified as dividends, resulting in additional corp tax, interest and penalties.

### **2.2.3. 2nd Tax.**

#### **2.2.3.1. Earnings.**

The highest federal & CA marginal:

- (i) individual income tax rate = 45.2172%; &
- (ii) corp. income tax rate = 41.045%.

Money accumulated in a C corp. might be taxed at the **top** corp. bracket & later distributed to a shareholder in **the** top individual bracket. **Worst case:** \$10 million of C income yields only  $\approx$  \$3.2 million to the shareholders.

#### **2.2.3.2. Corp Asset Sale.**

##### **2.2.3.2.1. Why Buyers Buy Assets, Not Stock.**

Buyers are advised to buy assets, not stock, for two reasons:

- (i) protect buyer from assuming selling corp's liabilities;
- (ii) buyer may assign an increased basis to the assets, resulting in a higher future depreciation deduction.

With that prejudice in mind, a buyer might be persuaded to buy stock - but the

purchase price will be **reduced** to compensate the buyer for:

- (i) extra risks assumed; and
- (ii) loss of the increased depreciation deductions.

#### **2.2.3.2.2. 2d Tax On "C" Shareholders.**

Assume:

- (i) your basis in the "C" stock is \$1K,
- (ii) your corp. has a \$10K basis in its assets, and
- (iii) corp sells assets for \$1,000,000 & will not continue.

Corp must pay Federal & State tax on its sale ( $\$1,000,000 - \$10,000 = \$990K$  in gain; generates a \$397,366 tax). It distributes the net sales proceeds ( $\$1,000,000 - \$397,366 = \$602,634$ ) to the shareholders. Shareholders are taxed at their own Federal & State rates (\$216,466.13). On a \$1,000,000 sale the total corp. & individual taxes are ( $\$397,366 + \$216,466 =$ ) \$613,832,  $\approx 61\%$ : Shareholders net only \$386,168.

#### **2.2.3.2.3. Why "C" Shareholders Sell Stock.**

Assume you can sell the stock in your "C" corp for the same \$1,000,000. There is no corp tax. Your personal Federal & California tax is \$359,200 or almost 36%. That saves \$254,632 compared to the corp's sale of assets.

#### **2.2.4. Accumulated Earnings Tax ("AET").**

Though not commonly asserted by the IRS, a corp's "unreasonable" accumulation of earnings can expose it to the punitive (28%) AET.

### **3. "S."**

"S" corporation status is elected by filing IRS Form 2553 and FTB Form 3560.

#### **3.1. Advantages.**

"S" avoids "C" corp problem:

**3.1.1. No Unreasonable Comp.**

**3.1.1.1. Federal.**

IRS will not attack "S" shareholder-employees for receiving "unreasonable" comp. Why? Even if the IRS attack is successful, no additional federal taxes are due.

**3.1.1.2. California.**

California has an incentive to attack compensation as unreasonable: it can get 1.5% of the disallowed compensation. With the state "S" tax rate that low, only extraordinarily profitable businesses are likely to be bothered.

**Example:** the following table displays the most important facts regarding a client that was attacked by FTB for unreasonable comp (our client won):

	88	89	90
sales	<b>\$80,000,000</b>	<b>\$90,000,000</b>	<b>\$100,000,000</b>
dividends	<b>\$ 1,000,000</b>	<b>\$ 4,000,000</b>	<b>\$ 8,000,000</b>
compensation	<b>\$12,000,000</b>	<b>\$14,000,000</b>	<b>\$ 14,000,000</b>
Total split by 3 owners	<b>\$13,000,000</b>	<b>\$18,000,000</b>	<b>\$ 22,000,000</b>

**3.1.2. Minimize Medicare Tax.**

S shareholders minimize salaries & increase distributions to limit Medicare taxes;

**3.1.3. Disallowed Expenses: No 2nd Tax**

Disallowed corp expenses will not, for federal tax purposes, cause corp. tax, interest and penalties;

**3.1.4. Shareholders Use Business' Losses.**

Losses pass through to the individual shareholder's return (assuming sufficient tax basis);

**3.1.5. Passive Activities.**

Individual losses from a passive activity may be offset against "S" passive activity income; and

**3.1.6. Asset Sale.**

No "double tax" if a corp sells its assets & distributes the net proceeds to its shareholders if it has:

**3.1.6.1.** always been an "S"; or

**3.1.6.2.** converted to "S" but has no more "built in gain."  
§1374.

**3.2. Disadvantages.**

**3.2.1. No Lower Corp Rates.**

"S" corps do not permit the accumulation of the first \$75,000 at the lower Federal corp tax rates.

**3.2.2. California's 1.5% "S" Tax.**

"S" corps must pay a 1.5% California tax on income.

**3.2.3. No Pension Borrowing.**

Shareholder-employees may not borrow from pension and profit sharing plans sponsored by "S" corps.<sup>1</sup>

**3.2.4. Shareholders Restrictions.**

Cannot have certain types of trusts (discretionary/accumulation trusts) as

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<sup>1</sup> The flush language at the end of §4975(d) includes in the phrase "owner-employee" of the plan sponsor (defined in §401(c)(3)) a "shareholder-employee" in an S corporation.

shareholders, which hinders estate planning. However, charitable and other tax-exempt trusts will be eligible as of 1/1/98. Cannot have non-resident aliens as shareholders. Cannot have more than 35 shareholders (legislation is pending to increase that number to 50). Cannot be a member of an affiliated group of corps, i.e., it cannot own 80% of another corp. (rules liberalized effective 1/1/97). Cannot have more than one class of stock (unless only difference is voting rights).

### **3.2.5. Fringe Benefits Unavailable.**

"S" shareholders who own more than 2% of the stock are treated as partners for fringe benefit purposes. IRC §1372. Therefore, certain employee benefits, such as an uninsured medical expense reimbursement program and group term life insurance, are not excluded from income.

### **3.2.6. Limited Fiscal Years.**

An S corp's year end is restricted to the months ending in September through December. Depending on the seasonality of your business and other factors, this limit could have an affect on tax planning opportunities.

## **4. PROFESSIONAL/LOAN-OUT PROBLEMS.**

### **4.1. Corps Subject To These Rules.**

A Qualified Personal Service Corporation is a corp:

"(A) substantially all of the activities of which involve the performance of services in...health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

(B) substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corps, or QPSCs...) by -

(i) employees ["Ees"] performing services for the corp in connection with the activities involving a field referred to in (A),

(ii) retired Eees...,

(iii) the estate of anyone described in...(i) or (ii), or

(iv) anyone else who acquired the stock [due to] the death of an individual described in...(i) or (ii) (but only for 2-years beginning on the date of ....death...)."

#### **4.2. No Lower Tax Brackets.**

QPSCs are ineligible for the 15% rate on the first \$50K & 25% on the next \$25K. Instead, they are subject to a flat 34% rate on all taxable income. §11(b)(2). Therefore, a C will pay 18.3% on \$75K of taxable income compared to 34% for a QPSC. That 15.7% disadvantage translates into an extra \$11,775 of tax/year.

Of course, if the individual professional is in a 39.6% tax bracket, there is still a theoretical benefit of accumulating income at 34% (if the business needs the funds and few professional firms need to continue accumulating capital). Otherwise, deferring funds at 34% now when they will ultimately be distributed to the professional at 39.6% makes no sense.

#### **4.3. Conclusions.**

Most pro/loan-outs probably should elect "S." **Main benefit:** disallowance of any corp expenses, e.g., entertainment, will not result in a double level of tax.

Some will continue to elect "C" status for the perceived audit advantage.

### **5. CPA's ROLE.**

#### **5.1. In General.**

Your CPA is your most important advisor in this process:

- (i) counseling you on whether "C" or "S" is better,
- (ii) preparing/filing the forms to elect "S," if needed, and
- (iii) preparing and filing the annual tax reporting forms.

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March 16, 2000

Page 9

## **5.2. Analyze.**

Meet with your CPA to analyze whether "C" or "S" is better. If you have not yet incorporated, making the "S" election saves you from an otherwise applicable ten (10) year period in which the 2d level of tax might otherwise apply.

## **5.3. Annual Tax Reporting.**

Both "C" and "S" corp must file tax returns. The federal income tax forms are the 1120 and 1120 S, respectively.

The principal difference between the two is that the 1120S includes a Form K-1 for each shareholder. That K-1 reflects:

"the shareholder's pro rata share of the corp's -

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss." §1366(a)(1).

K-1s are issued to the shareholders, and the information is reflected on each individual's income tax return.