# Taxation Of Corporations – C-Corporation And S-Corporation

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There are generally two ways corporations may be taxed under the federal rules. By default, a corporation is taxed under Subchapter C of the Internal Revenue Code. However, a corporation may instead elect to be taxed under Subchapter S of the Internal Revenue Code.

The selection of a certain type of entity structure or election of a particular tax status is an individualized decision that will depend on the characteristics of the business itself and the business owner's surrounding circumstances. In one aspect, there may be certain advantages in choosing one type of entity or tax structure over another, while there may be disadvantages in another aspect. For example, in the context of investment real estate, it is sometimes preferable for the property to be held by an LLC rather than a corporation. Whether a corporation should refrain from making the 'S' election and continue to be treated as a C corporation or in fact make the 'S' election and become subject to the rules that govern S corporations is a decision that should be guided by a qualified advisor.

**WHAT STANDARDS APPLY TO C CORPORATIONS?**

In order to qualify as a C corporation, the entity must meet the following requirements: (1) it must be a domestic corporation that is in existence for the tax year; (2) it must file Form 1120 annually even it does not have any business activity or profits unless it is a tax-exempt organization (in which case it must file Form 990); and (3) it must file quarterly estimated tax returns if the entity expects for its taxable income to exceed $500 during the tax year.

A C corporation may be an ordinary corporation, professional corporation, non-profit corporation, closely held corporation, public corporation, or even a single owner-shareholder corporation. A C corporation is generally taxed on its earnings on two separate occasions; once when the income is earned by the corporation and again as earnings are distributed to the shareholders.

Under the new tax laws ("TCJA"), C corporations are now required to pay a 21% flat tax on their corporate earnings. For purposes of this example, assume the corporation's income is $100,000. After applying the 21% rate, the net amount to the corporation is $79,000. After making distributions to the shareholder in the full amount, the shareholder pays 23.8% capital gain tax, which amounts to $18,802. As such, the total amount of taxes paid by the corporation and the shareholder may be as much as $39,802. Therefore, the combined tax rate on the $100,000 business income may be as much as 39.8%.

**Capital Contributions by Shareholders**

The capitalization of a corporation is initially effectuated by a shareholder who transfers money, property, or services in exchange for ownership of stock. The contribution of cash to the corporation in exchange for stock is generally not a taxable event. The amount of cash contributed by the shareholder will generally determine the shareholder's basis of stock in the corporation.

On the other hand, transfer of property is treated as a sale to the corporation. As a result, there may be tax owed by the shareholder if the property's adjusted basis is less than the fair market value at the time of transfer. In such instances, the shareholder's basis of the contributed property transfers to the corporation. However, if the shareholder contributes property in exchange for stock and controls the corporation immediately after the transfer, the shareholder will generally not recognize the gain on the transfer.

The standard for control within the meaning of Section 351 of the Internal Revenue Code is met if the shareholder owns 80% or more of the total combined voting power of each class of voting stock and 80% or more of the outstanding shares of each class of nonvoting stock. This rule applies to both individuals and entities that transfer property to a corporation.

If the shareholder receives anything other than stock, such as cash or property, he would have to recognize gain to the extent of the money received plus the fair market value of the property received. However, if the corporation assumes liabilities as a result of a property transfer, it is generally not deemed as money received by the shareholder except under certain circumstances, such as if there is no legitimate business purpose for the corporation to assume the liabilities or if the liabilities assumed by the corporation are more than the shareholder's adjusted basis in the property transferred.

**Earnings and Profits**

Earnings and Profits ("E&P") are critical for measuring corporate transactions and calculating a C corporation's taxable income. E&P is used to determine whether a distribution is a taxable dividend for the C corporation, a nontaxable return of capital to the shareholder, or a capital gain to the shareholder. As a general rule, a distribution is treated as a dividend to the extent of a C corporation's current-year E&P. If there is no current-year E&P or the current-year E&P is depleted, the distribution will constitute a dividend to the extent of the corporation's accumulated E&P from the prior years.

E&P should be tracked from the date of the corporation's formation until the current tax year. If it is not tracked, it may become very difficult for even the most experienced tax specialists to backtrack (in some instances for decades) and examine all of the corporation's records ever since its inception, including its financial statements and tax returns.

It should be noted that while some transactions may increase or decrease a corporation's E&P, the very same transactions may have no effect on the federal income tax calculations. The opposite also holds true. For example, life insurance proceeds are not taxable to the corporation, yet they increase a corporation's E&P. Similarly, the annual federal income tax amount is generally reduced in the E&P calculation, however, it cannot be deducted on the federal taxes.

Accumulated E&Ps are the earnings and profits that a corporation had acquired in a prior year but did not distribute to its shareholders. In the event the corporation's E&P for the current year is less than the amount of the distributions it made during the current year, a part or all of the distributions are treated as accumulated E&P. Therefore, if the corporation does not have sufficient E&P for the current year to offset the amount of dividends it distributed to its shareholders, the difference is treated as accumulated E&P.

If the accumulated E&P is depleted (meaning it reaches zero), the remaining portion of the distribution to the shareholder reduces the adjusted basis of the shareholder's stock. This portion is not taxable because it is deemed a return of capital. If the corporation makes no dividend distribution which exceed the adjusted basis of the shareholder's stock, the difference is treated as a gain from a sale or exchange of property. Therefore, the shareholder would owe capital gain taxes under that scenario.

To illustrate the application of E&P, consider the following hypothetical. Sherry, a shareholder of C Corp stock, has an adjusted basis of $5,000. C Corp's accumulated E&P was $30,000 for the prior years and $60,000 for the current year. C Corp makes a distribution to Sherry in the amount of $100,000. First, the $60,000 portion of the distribution will be treated as a dividend from the current year's E&P. Second, the $30,000 portion will be treated as a distribution from the accumulated E&P from the prior years. The remaining $10,000 will reduce Sherry's basis in C Corp's stock to zero. Even though Sherry will not be taxed on the first $5,000 since it is a return of capital, Sherry will be taxed on the remaining $5,000, in addition to being taxed on the $90,000 from the current-year and accumulated E&Ps.

**Accumulated Earnings Tax**

One of the advantages of C corporations is that it may be allowed to withhold distributions of its earnings to its shareholders. Generally, C corporations may accumulate their earnings up to $250,000 ($150,000 for personal service corporations). If the accumulated earnings exceed the specified amount, 20% tax may be assessed on any portion that exceeds the allowed threshold unless the accumulations are for the reasonable needs of the business.

If the accumulations are for the reasonable needs of the business, the 20% tax generally will not apply. Reasonable needs include possible expansion or other reasonable business reasons. Other examples include construction of new facilities, purchasing new equipment, and acquiring another business through the purchase of stock or assets. However, granting shareholders the ability to draw personal loans from the corporation is generally not deemed a reasonable business reason.

**Distributions to Shareholders**

A corporation may receive profits from a variety of sources, including from sales of goods, services, and income-producing assets. Unlike S corporations, the character of the income is not retained by the shareholder of a C corporation when a distribution is made to the shareholders. For example, if a corporation receives income from rental property, the shareholder merely receives a dividend. This is significant if you consider that the capital gain rates may potentially be more favorable than the ordinary rates. Therefore, if a capital asset (e.g., real estate) is sold by the corporation, the shareholder will not be able to retain the capital nature of the asset.

If a corporation earns profits, it may retain the profits to the extent allowed under the law. Alternatively, the corporation may declare some or all of the profits as distributions to the shareholders in the form of dividends. Dividends are usually distributed in cash. There are other forms of corporate distributions including distributions of property, non-dividend distributions, capital gain distributions, and distributions of stock or stock options.

The amount of dividends the corporation pays to its shareholders are not deductible by the corporation. Unlike shareholders of S corporations, shareholders of C corporations cannot deduct the losses of the corporation. Since C corporations are also taxed on the entity level, only the corporation can deduct the corporate losses.

The dividends a corporation declares to a shareholder of a C corporation stock may either be treated under the ordinary rates or the more favorable capital gain rates. The treatment will depend on whether the distribution is in the form of a qualified dividend or a non-qualified dividend. If the distribution is a byproduct of a qualified dividend (i.e., distributed from a typical corporation formed under the laws of the United States), the shareholder may pay tax on the more favorable capital gain rates. If the distribution is a byproduct of a non-qualified dividend, the shareholder may pay tax under the less favorable ordinary rates.

Note that salaries or wages paid to employee-shareholders are not considered distributions. Instead, the wages are treated as business expenses similar to the wages of the corporation's other employees. Consequently, the wages are deductible by the corporation and taxable to the employee-shareholder. In addition, a C corporation may deduct the fringe benefits it provides to its shareholder-employee. For the shareholder-employee, the fringe benefits are tax-free.

There are special standards for distributions of property to the shareholders. If the corporation distributes property to a shareholder, the fair market value of the distributed property becomes the shareholder's basis in the property. However, the amount of the dividend may be reduced by the amount of liabilities assumed by the shareholder, or any liability that is subject to the distributed property (e.g., mortgage). The fair market value of the property is determined by the greater of the actual fair market value of the property or the amount of liabilities assumed by the shareholder.

Distributions of property to shareholders are generally treated as sales just as when shareholders transfer property to a corporation. As such, the corporation would have to recognize a gain if the fair market value of the property exceeds the corporation's adjusted basis in the property. For example, if the distribution includes a tractor with an adjusted basis of $20,000 and fair market value of $45,000, the corporation would have to recognize the gain of $25,000. However, if the fair market value of the property is less than the adjusted basis of the property, the corporation generally cannot recognize a loss on the distribution to the shareholder.

Distributions of stock occur when the corporation issues additional shares of its corporate stock to its shareholders. Neither distributions of stock nor stock options are generally taxable to the shareholders. However, they are also not deductible by the corporation. The distributions of stock or stock options may be deemed taxable property distributions under some circumstances, such as when the shareholder has an option to receive cash or property but chooses instead to receive stock or stock options.

Constructive distributions occur in the event that the corporation confers a benefit upon the shareholder. If such a transaction was previously categorized as an expense, it may later be reclassified as a constructive distribution. As a result, the transaction would generally be nondeductible for the corporation and taxable to the shareholder. Examples of constructive distributions include payment of personal expenses, cancellation of shareholder's debt, unreasonable compensation, and property transfers for less than fair market value.

**Capital Losses**

Where individuals are generally allowed to offset their capital losses against their other income up to a certain limit, C corporations cannot offset their capital losses against their other income. For example, let's assume a C corporation which operates a pizza parlor had a capital loss of $20,000 in 2018 when it sold its delivery vehicle (capital asset). However, it cannot deduct the $20,000 loss from the sale of the vehicle against the profits it made from the sales of pizzas. On the other hand, if it recognized a gain in the amount of $20,000 from selling a pizza oven (capital asset), the $20,000 gain from the sale of the pizza oven would likely offset the $20,000 loss from the sale of the delivery vehicle.

As a general rule, if the capital losses exceed the capital gains for the tax year, it cannot deduct the excess losses for that year. Instead, it may only carry the losses back or forward to other tax years in order to deduct the losses from any net capital gains it had during those years. Generally, it can carry back the net capital losses to three years and carry forward to five years. Any unused portion after the five-year period will be lost.

**Net Operating Losses**

Net operating losses ("NOL") occur when a corporation's deductions are greater than its taxable income. NOL can effectively reduce the income taxes for the subsequent years. Prior to TCJA, C corporations were allowed to offset their NOL with 100% of their taxable income, subject to the two-year carryback and 20-year carryforward periods. Under TCJA, the NOL deduction is now limited to 80% of the taxable income. Subject to some exceptions, the carryback rule has been largely eliminated. However, TCJA allows for an indefinite carryforward instead of the 20-year carryforward period permitted prior to TCJA.

To illustrate the impact of TCJA in the context of NOL, suppose that a C corporation incurs $200,000 NOL in 2019 and generates $100,000 taxable income in 2020. The NOL of $200,000 for 2019 can be indefinitely carried forward to subsequent years. Since the corporation may only offset 80% of the taxable income for the 2020 tax year, it is only eligible to offset $80,000 from its $100,000 taxable income. The remaining NOL of $120,000 may not be carried back, but it may be carried forward indefinitely to offset up to 80% of the taxable income in the subsequent years.

## WHAT STANDARDS APPLY TO S CORPORATIONS?

An S corporation is a pass-through entity. Even though both partnerships and S corporations are pass-through entities – unlike partnerships – shareholders of S corporations do not have the ability to form advance agreements in order to allocate the entity's profits and losses. Instead, all of the earnings and expenses pass through to the shareholders based on their percentage of ownership in the corporation.

### Requirements For Qualification And Compliance

In order to qualify as an S corporation, the entity must meet the following requirements: (1) it must be a domestic corporation; (2) it generally cannot have more than 100 shareholders; (3) it must have only one class of stock; (4) the business must satisfy the definition of a small business corporation under Section 1361 of the Internal Revenue Code; and (5) shareholders that are individuals must generally be U.S. citizens or residents (shareholders that are corporations or partnerships are generally excluded).

For a calendar year corporation to be eligible to make the 'S' election, it must file Form 2553 generally within the first two and a half months of the tax year, if it is seeking for the S corporation treatment to be effective for that tax year. The S corporation must always file a tax return irrespective of its income and losses unless the corporation has been dissolved. The tax returns are filed on Form 1120S.

The shareholders are required to pay estimated taxes if their own tax returns have exceeded or are expected to exceed $500 when the returns are filed. The shareholders are required to report all applicable categories of earnings and losses on Schedule K-1. Shareholders of S corporations must pay taxes on their share of the corporate income regardless of whether distributions are made. The amount of taxes the shareholders may pay is contingent upon their stock basis in the S corporation.

### Determining Stock Basis

The basis of the corporate stock is critical since both the taxability of a distribution and the deductibility of a loss are contingent upon the shareholder's stock basis. The basis may be adjusted annually. It is the individual shareholder's obligation to track his or her own basis in the corporate stock.

The starting point for determining a shareholder's basis in an S corporation stock is the initial contribution by the shareholder. Basis is generally determined by how the stock was initially acquired. Generally, the stock of a corporation may be acquired in a number of ways including by purchase, gift, or inheritance.

If the stock was acquired by purchase, the basis of the stock is generally the initial cost of the shares. If it was acquired by gift, the shareholder's basis is generally the donor's basis in the stock. If it was acquired by inheritance, the shareholder's basis is generally the fair market value of the stock on the date of the former shareholder's death. If it was acquired by the shareholder's performance of services, the basis of an S corporation stock is measured by the fair market value of the stock at the time the services were rendered (unlike in C corporations where the basis is determined by the fair market value of the services rendered).

If the stock was acquired in accordance with Section 351 of the Internal Revenue Code (where the shareholder acquired control of the corporation immediately after the transfer of property), the basis of the stock is any cash invested, increased by the basis of the property transferred to the corporation, increased by any gain recognized on the transfer, decreased by any boot received from the corporation. If the corporation was operating as a C corporation prior to making the S election, the basis in the S corporation stock is the basis in the C corporation stock at the time of transfer.

**Distributions To Shareholders**

Distributions by S corporations are generally not treated as dividends. The distributions themselves are not subject to income tax unless they exceed the shareholder's adjusted basis in the stock. If the corporation makes a distribution of property, the distribution is treated as a sale to the shareholder. If the fair market value of the property exceeds the corporation's adjusted basis, the corporation would recognize the gain. However, the corporation would not recognize a loss if the fair market value of the property was less than the corporation's adjusted basis in the property.

Distributions that exceed the shareholder's basis in the corporate stock are treated as capital gains. When the gain passes through to the shareholder, yet a distribution is not made to the shareholder, the gain increases the basis in his stock. However, if a distribution is made, the shareholder's basis may be reduced to the extent of the difference between the distribution and the shareholder's basis in the stock.

To illustrate how basis calculations are relevant to shareholders of S corporations, consider the following example. Shane is the sole shareholder of S Corp whose stock basis is $5,000. S Corp earned $5,000 in 2019. If a distribution is not made to Shane in 2020, his new basis in the stock will be $10,000. If Shane instead receives a distribution in the amount of $10,000, his basis will be reduced to zero since he would have a return of capital on his stock. The remaining $5,000 will be treated as a capital gain because Shane received an extra sum of money after his basis was reduced to zero.

**Reasonable Compensation**

Instead of making a distribution, an S corporation may provide salaries or wages to its employees. However, salaries and wages are subject to employment taxes whereas distributions are not. If the distributions are received by a shareholder-employee and he or she is not receiving reasonable compensation for the services provided to the corporation, the distributions may be reclassified as wages (in which case they may be subject to employment taxes). The IRS does not have any specific guidelines with regard to reasonable compensation. However, the factors that are considered include training and experience, dividend history, the amount that similar businesses pay for similar services, and compensation agreements.

**Qualified Business Income**

Since Congress (specifically the GOP) provided significant benefits to C corporations under TCJA by reducing the top rate from 35% to 21% and repealing the Alternate Minimum Tax for corporations, they also assumingly wanted to provide significant benefits to pass-through entities. Under TCJA, there is a new deduction available for pass-through entities under Section 199A of the Internal Revenue Code. For purposes of the new law, pass-through entities include S corporations, sole proprietorships, limited liability companies, partnerships, trusts, and estates. This deduction is known as Qualified Business Income ("QBI").

Even though QBI is available for pass-through entities more broadly, the following analysis is based on the shareholder-employees of S corporations. Generally, the QBI deduction allows business owners of pass-through entities to potentially receive up to a 20% deduction on their business income. The two primary sources of income available to shareholder-employees generally boil down to two categories: compensation for services and business profits.

The portion of the income represented by the business profits is the amount that is available after the shareholder receives reasonable compensation for his or her services. Compensation for services comes in the form of W-2s and it is classified as wages. The portion of the income that qualifies as business profits (e.g., K-1) is the amount that exceeds the W-2s. It is this (business profits) portion of the shareholder-employee's income that is potentially entitled to the QBI deduction.