Advantages of a C Corporation

In deciding which form of entity to use for a new small business venture, the potential benefits of a C Corporation should be considered. A C corporation may have relative advantages and benefits over other entity forms.

The significant disadvantages of a C corporation are well known:

- Double taxation of appreciated assets on sale or dissolution;
- High corporate income tax rates on annual income in excess of $75,000; and
- Tax traps for accumulated earnings and personal holding companies.

However, there are also significant advantages, especially for non-personal service corporations (non-PSCs):

- Low tax rates on the first $75,000 of annual income for non-PSCs;
- Availability of a fiscal year for non-PSCs;
- Superior fringe benefits for owner-employees;
- Different audit potential than passthrough entities;
- Sec. 1202 reduced rate of capital gains taxation on the sale of qualified small business stock; and
- Sec. 1244 ordinary loss deduction for a failed small business C corporation.

Low tax rates: The C corporation is a niche choice for small business. It allows a non-PSC business to accumulate capital at low tax rates for funding accounts receivable, inventory, and fixed assets. In an S corporation, limited liability company (LLC), partnership, or proprietorship, capital is taxed at the individual's marginal tax rate, often with FICA liability. If the C corporation's taxable income can be managed so it does not exceed $75,000, it can achieve significant front-end tax savings, which can greatly reduce the cost of acquiring capital to use in a business.

Fiscal year: Non-PSCs are permitted to use a fiscal year. (PSCs can use a fiscal year with a Sec. 444 election, but there is no benefit to this complex procedure.) A fiscal year spans two calendar years, allowing an owner-employee some leeway to control the calendar year in which he or she will recognize salary income and when the C corporation will realize a deduction.

Fringe benefits: When most of the owners of a C corporation are also employees, a self-insured medical reimbursement plan under Sec. 105(b) is a viable option. It allows the C corporation to pay all medical expenses not reimbursed by insurance, including some over-the-counter medications (Rev. Rul. 2003-102). The corporation can also deduct disability insurance for owner-employees.

Audit potential and tax liability: The audit potential for C corporations and their owners is different than it is for other entities and their owners. There is no income or loss passthrough from a C corporation to raise the owners' individual audit potential. An audit of a C corporation may lead to adjustments that result in taxation at unplanned high corporate income tax rates—or worse, as a dividend to shareholders, resulting in double taxation. However, the owners of a C corporation generally will not be liable for any additional taxes assessed to the C corporation due to an audit. If a tax assessment exceeds the value of the business, the owners may be able to simply abandon the bankrupt C corporation and walk away from tax debt. In a passthrough or disregarded entity, the tax liability of the business falls directly on the owners.

Sec. 1202: When a shareholder sells or redeems shares, Sec. 1202 benefits may be available. Sec. 1202 allows 50% of the gain on qualified small business stock to be excluded from income, with the balance taxed at 28%—an effective rate of 14%. If a taxpayer is subject to the alternative minimum tax (AMT), the AMT adjustment for gain from the sale of qualified small business stock creates an effective 15% capital gains tax rate. However, the additional 1% AMT is a credit that may be claimed in subsequent years on Form 8801, Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts, until fully used (which might take decades). The real advantage in Sec. 1202 is that, in states that allow this exclusion, state capital gains taxation can be cut in half.

To qualify for Sec. 1202, the shares must be held for at least five years, at least 80% of the assets must be used in a trade or business, and the business must not be a personal service provider (such as an accountant, actuary, attorney, architect, or other business in which the product is the employees' knowledge), among other technical requirements.

Sec. 1244: If the corporation fails, Sec. 1244 allows a full deduction, up to $100,000 for joint taxpayers ($50,000 for single taxpayers), as an ordinary loss. Dissolution of the cor-poration in recognition of the loss may be planned for a year in which the owners will have sufficient income to offset the loss. For example, the owner might be able to realize these losses as an offset to salary after arranging for new full-time employment. In addition, should the loss be claimed in the wrong year, Sec. 6511(d)(1) provides a seven-year statute of limitation for a taxpayer to take corrective action to claim the loss in the proper year. In contrast, with a passthrough or disregarded entity, unless the owner has income from other sources, he or she may be unable to use losses in the year incurred.

Other Considerations: The current 15% tax rate on qualified dividend income allows distribution of corporate income at low rates. While this is in effect, the total corporate income tax plus individual dividend tax may be less than the total tax on salary with FICA. The C corporation need not be exclusive; it can be an operating entity combined with non-C entities. The other entities can hold real, personal, or intangible property that may appreciate in value and cause tax problems if held in a C corporation. However, care should be taken to avoid a tainted PSC under Sec. 269A, which performs services for one other entity in which a principal purpose is to avoid, evade, or reduce taxes. If a PSC is subject to Sec. 269A, the IRS may allocate income, credits, deductions, exclusions, and other allowances between the corporation and its employee-owners in order to prevent the evasion or avoidance of tax.

Once the C corporation is successful, having accumulated all its capital needs, it might elect and maintain S status for the requisite 10 years and avoid the Sec. 1374 tax on built-in gain, thereby avoiding the double tax on appreciated assets on sale or dissolution. Meanwhile, as a C corporation it can accumulate capital at lower income tax rates.

Renting property to one's C corporation is another way to extract earnings without incurring FICA. Under Regs. Sec. 1.469-2(f)(6), net rental income from certain C corporations is treated as nonpassive income, while net rental losses are treated as passive.

When multiple entities are used, care must be taken to properly elect and allocate the deduction and credit limits allowed to controlled groups. Multiple payroll filings need not pose a problem, nor should excess payroll taxes, when the entities take advantage of the "common paymaster" pro visions of Secs. 3121(s) and 3306(p).

Few PSC Advantages: There are few advantages in using a C corporation for a PSC because of the required calendar year and the 35% flat income tax (Sec. 11(b)(2)). A PSC is defined in Sec. 448(d)(2) as any corporation that performs substantially all of its activities in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and is owned by its employees or assigns.

PSC advantages include the ability to use a medical reimbursement plan and some limited flexibility to manage income for owner-employees. Income could be planned to show a profit and owe corporate income tax in year 1, while generating a net operating loss (NOL) in year 2 for a carryback refund; or an NOL can be created in year 1 for carryforward to year 2. Timing of owner-employee salaries can help generate the desired result. This option can be especially useful to smooth out salary variations for maximizing retirement plan contributions or to take advantage of changing tax rates.

Conclusion: When faced with a choice of entity, the benefits of a C corporation (or combination with a pass-through entity) should not be ignored. A C corporation will be an infrequent choice, but it can be the right choice in certain situations. A C corporation is not limited to entities incorporated under state law; an LLC or partnership can elect under Regs. Sec. 301.7701-3(c) to be treated as an association taxed as a corporation by filing Form 8832, Entity Classification Election.

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