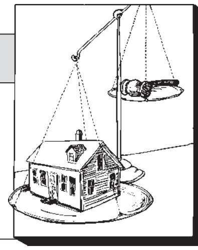

S or C? Incorporation and Taxes

by Lisa N. Davis

My last article discussed some of the differences between sole proprietorships, partnerships, and S and C corporations (see Legal, 3/92). Since more and more small contractors are incorporating, it makes sense to take a closer look at the differences between S and C corporate forms. Most of these have to do with taxes, though some have to do with the structure of the corporation.

If you're choosing or changing corporate forms, bear in mind that tax laws can and do change, and there can be costs involved with changing your corporate status or liquidating the corporation in response to tax changes. Consider carefully where your company will go in the next few years, and be sure to consult an accountant or attorney before taking any definite steps.

S Corporations And Double Taxation

The most important difference between S and C corporations is how they are taxed. A C corporation pays corporate taxes on its profits, and the individual stockholders pay personal income taxes on their dividends — the so-called "double taxation." Both tax rates vary depending on the respective incomes of both the corporation and the shareholder — the corporation's is based on the amount of corporate profit, the shareholder's on his or her personal income (including dividends received). An S corporation, on the other hand, pays no federal corporate taxes itself; only the stockholder pays federal income taxes, based solely on his or her personal tax bracket.

Because of this situation, an S corporation, because it divides the profit pie into numerous wedges, often sees its profits taxed at a lower rate than a C corporation making the same profit — provided, that is, that the wedges are small enough to fall into relatively low tax brackets. For instance, $100,000 in total corporate profits would be taxed at a higher rate as C corporation profits than the same amount distributed in $25,000 portions to each of four S-corporation shareholders.

Some states tax all corporations, whether S or C, like C corporations. Be sure to factor in any such state tax laws when comparing corporate forms.

The Capital Gains Catch

Another distinction between S and C corporation taxation is taxation on capital gains. If an S corporation has capital gains (for example, profit from the sale of land or equipment), the individual stockholder's received share of those gains is treated as capital gains. C corporation dividends, on the other hand, are always treated as ordinary income for the purposes of tax paid by the stockholder. While capital gains and ordinary income are now taxed at the same rates (ranging from 18% to 31%), the Bush administration is trying to cut the capital gains tax to a flat 15%. If it succeeds, the change will likely make subchapter S status even more attractive for companies anticipating capital gains.

Deductions: Wages And Salaries

Taxes for both types of corporations are based on the corporation's *net* income or profit — what's left over when the corporation has paid its expenses, including wages and salaries. This presents another wrinkle in the S vs. C tax picture. If your C corporation turns enough profit that the corporation's tax bracket is higher than yours, you can raise your salary to reduce or eliminate the company's profits, so that the corporation pays less tax. (If your salary is "unreasonably" high, the IRS may treat some of it as a dividend anyway.)

The flip side is that if you control an S corporation, you can save tax money another way: You can keep your salary low to raise corporate profits, then distribute the profits to yourself in the form of dividends instead of wages. By doing this, you can avoid paying state and federal unemployment tax on the wages, and the amount paid for social security tax is slightly reduced. Be careful, though: If you make your salary too low, the IRS will characterize the dividend as wages and make you pay all those wage taxes anyway.

Deducting Fringe Benefits

There are yet more wrinkles in this picture. A C corporation can deduct, in full, the cost of fringe benefits paid to its employees. An S corporation can (at least until July 1992) deduct only 25% of certain fringe benefits, such as health insurance premiums, paid to or for employees who also own more than 2% of the stock. (The employee may have to pay income tax on the premium anyway.) After July 1992, that 25% will be reduced to 0%. (Note: Bush's proposed tax package may increase this to as much as 100%.)

There are still other differences. For instance, an S corporation stockholder-employee can't deduct for the business use of his home, and if he owns more than 5% of the stock, he can't take a loan from his retirement plan either. These restrictions can really increase your taxes if you're an owner-employee, especially if the company's earnings are not too high.

Phantom Profits and Losses

When business is good, being an S corporation is a mixed blessing. S corporation stockholders pay tax on their shares of the profits, whether or not they actually get dividends. If profits are reinvested or set aside for a rainy day, all the shareholders must still pay taxes on these "phantom" profits, even though they don't actually receive the cash. This may be fine if you're the only stockholder. Other stockholders, however, may want their shares of the profits paid out, since they will have to pay taxes on them anyway.

On the other hand, when an S corporation suffers losses, stockholders who "materially participate" in the business (help operate it) may deduct their shares of the losses from whatever other income they may have (including income received as wages or salary from the company). This tax shelter in poor times can help make up for taxes paid on phantom profits in good times, but not if the major shareholders are just passive investors. (Bush's tax plan may allow passive investors in real estate to take this deduction as well.)

When You Dissolve Your Corporation

Finally, there are considerable differences between the S and C forms in how they are taxed when the corporation is dissolved and the assets distributed to the stockholders. This situation is complex, but it comes down to the fact that S corporations often incur less tax liability when dissolving and distributing their assets (particularly depreciated assets like machinery) than C corporations. This problem can, in part, be avoided in C corporations by keeping big assets out of corporate ownership by renting them from someone — perhaps yourself or another shareholder. But, in general, if you think you may be creating a new corporation for a particular project that, upon completion, will be dissolved, the S corporation may be for you.

Careful With Those Open Loans

It's worth mentioning one final tax fact about S corporations: Loaning your company money can get you into trouble if you're not careful.

S corporations can only have one "class" of stock. In some cases, the IRS has ruled that stockholder loans to the corporation can create a second "class" of stock, because the lending stockholder, as a creditor, gets priority over regular shareholders if the company files for bankruptcy. Therefore, the IRS may characterize some stockholder loans as a kind of super-preferred stock in a different "class" from the company's other stock, in which case the corporation could lose its S status.

The IRS has proposed some safe harbors to avoid this trap, such as exceptions made for "straight loans" with set interest rates and due dates, and for "unwritten" loans under $10,000. But, in general, these restrictions on stockholder loans can cause problems if an S corporation hits hard times, because they prevent you from making open-end loans to bail out the company.

The tax implications of S and C corporations are so complex, so various, and can so easily change depending on accounting practices, amount and distribution of profits, and changes in law, that choosing a corporate form requires careful thought and considerable tax planning. Whatever you decide, be sure to retain an attorney, accountant, or other tax consultant to keep you advised about changes in the tax laws that may affect your corporation. ■

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