BRADFORD
TAX INSTITUTE

March 2020

Beware of the Dark Side When Considering the C Corporation

The Tax Cuts and Jobs Act (TCJA) makes the idea of operating your business as a C corporation more attractive than before.

Reason. The TCJA created a flat 21 percent corporate federal income tax rate. That low rate applies equally to garden-variety C corporations and to personal service corporations.

Compare the 21 percent corporate rate to the 37 percent maximum federal income tax rate for individual taxpayers, and you can see why the C corporation status seems golden.

But there's more to the story. C corporations face tax issues that don't affect sole proprietorships, single-member LLCs treated as sole proprietorships for tax purposes, and pass-through entities (partnerships, multimember LLCs treated as partnerships for tax purposes, and S corporations).

Here's what you need to know about the potential tax negatives of running your business as a C corporation.

Conventional Wisdom Then and Now

Before the TCJA, conventional wisdom dictated that you should conduct most small and medium-sized businesses via pass-through entities because that avoided the dreaded double-taxation issue that haunts C corporations.

The double-taxation threat still exists, but the 21 percent corporate rate lessens the danger. So, after the TCJA, conventional wisdom is not so cut-and-dried.

- Pass-through entity status is still advisable in some circumstances (such as when a business will incur losses or will pay out most or all of its profits to its owners every year).

- C corporation status is also advisable in some circumstances (such as when your business needs to retain most or all of its profits to finance growth).

Also, C corporation status looks better if you believe that our beloved D.C. politicians

- will probably allow the current 21 percent corporate tax rate to stay in place, and

- will almost certainly raise personal income tax rates sooner or later (probably sooner).

Paying a 21 percent tax rate is better than paying 37 percent or higher. Right? Yes, but beware of the C corporation tax caveats covered in the rest of this article.

Double Taxation of Corporate Dividends

Say you run your business as a C corporation. The business is successful, and your corporation builds up a hefty amount of earnings and profits (E&P).

While lots of E&P (a tax accounting concept similar to the financial accounting concept of retained earnings) indicates a financially healthy operation, it also creates tax concerns when you try to get money out of the company.

Double Taxation of Dividends Explained

To the extent your C corporation has current or accumulated E&P, non-liquidating corporate distributions to shareholders (like you) count as taxable dividends.[1]

Since the current federal income tax rate on dividends received by individuals cannot exceed 23.8 percent (the 20 percent maximum rate plus 3.8 percent for the net investment income tax, or NIIT), dividends paid while the current rates are in force will be taxed relatively lightly.

But it could be a different story in future years if lawmakers increase the tax rates on dividends. Back in the day, dividends were taxed as ordinary income—at the higher rates. There’s no guarantee we won’t go back to the past in terms of how lawmakers will tax dividends in the future.

If that happens, C corporations won’t be nearly as attractive as they are under the current tax rate regime.

Accumulated Earnings Tax Can Be Assessed If Dividends Are Not Paid Out

You might ask: “Can’t my C corporation avoid the double-taxation problem simply by *not* paying dividends?” Answer: that may not work.

When your C corporation retains a significant amount of earnings rather than paying them out as double-taxed dividends, there’s a risk of the IRS hitting the company with the dreaded accumulated earnings tax.

Accumulated Earnings Tax Explained

The accumulated earnings tax is a corporate-level tax assessed by the IRS, as opposed to a tax that is paid voluntarily with your company’s corporate tax return.

The IRS can assess the accumulated earnings tax when (1) the corporation’s accumulated earnings exceed $250,000, or $150,000 for a personal service corporation, and (2) the corporation cannot demonstrate economic need for the “excess” accumulated earnings.

When the accumulated earnings tax is assessed, the rate is the same as the maximum federal rate on dividends received by individual taxpayers (currently 20 percent).[2]

But if in the future dividends are once again taxed at ordinary income rates (as was the case back in the day, before the Bush tax cuts), the accumulated earnings tax rate would skyrocket accordingly. Reverting to the ordinary income treatment of dividends would not be good for the C corporations of the world.

Key Point. The whole idea behind the accumulated earnings tax is to discourage the strategy of not paying out corporate dividends to avoid double taxation. With the accumulated earnings tax, the feds achieve double taxation via the back door.

Zeroing Out Corporate Taxable Income with Compensation Paid to Shareholder-Employees Is Not Foolproof

Okay, so you now understand that C corporation dividends are potentially subject to double taxation, and that not paying dividends could trigger the dreaded accumulated earnings tax.

“So,” you ask, “why not just pay out all or nearly all of my C corporation’s annual profits as tax-deductible compensation to me (and other shareholder-employees, if any)?” That way, you avoid double taxation because your corporation’s taxable income is zeroed out (or nearly so).

You'll have to pay personal income taxes on the compensation, but that's okay, because the current federal income tax rates are pretty low by historical standards. Great idea! But . . .

The zero-out strategy works only as long as the purported compensation paid to the shareholder-employee(s) is "reasonable." If the purported compensation exceeds what's deemed reasonable, and if the IRS discovers this during an audit, the IRS can reclassify some or all of the purported compensation as double-taxed disguised dividends.

Needless to say, the issue of what constitutes reasonable compensation has been the subject of much litigation between the IRS and taxpayers.

Taxpayers have tended to win when

- almost all of the corporation's income is derived from the personal efforts of the shareholder-employees (such as with a medical or dental practice); or

- the claimed compensation deductions did not reduce the corporation's income beyond the point where a hypothetical independent investor in the company would be dissatisfied with his or her rate of return; or

- current compensation was set at high levels to make up for earlier years when the corporation did not have the funds to fully compensate the shareholder-employee(s), such as with a company that has only recently advanced beyond the cash-short start-up phase.

Case in Point

In a 2016 decision, the Tax Court upheld IRS-assessed additional taxes and penalties against a law corporation that claimed compensation deductions for purported year-end bonuses paid to shareholder-employees. The purported bonuses were found to be disguised dividends.

The claimed bonus deductions completely eliminated the corporation's book income, even though the corporation had income from substantial invested capital.

So, the corporation failed the aforementioned hypothetical independent investor test, which indicated that the purported bonuses were not reasonable compensation. Other factors supported the finding that the purported bonuses were disguised dividends.[3]

For details on this court case, see Tax Court Puts Personal Service Corporations on Notice for Bonuses.

Takeaways

- In the right circumstances, operating your business as a C corporation rather than as a pass-through entity can be a tax-smart move.

  But be aware of the tax caveats surrounding C corporation status.

- When evaluating the C corporation option, consider the possibility of future unfavorable changes to the federal income tax regime.
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- Do a side-by-side comparison of the after-tax results when considering the C corporation versus your current operating entity.

SIDEBAR: C Corporation Status Still a Bad Idea If Your Venture Involves Assets Likely to Appreciate

Even with the 21 percent tax rate, you still generally don’t want to have a C corporation hold significant assets that are likely to appreciate—such as real estate and valuable intangibles. If the corporation eventually sells the assets for substantial gains, you may be unable to get the profits out of the corporation without double taxation.

In contrast, if you hold appreciating assets in a pass-through entity such as an S corporation or a partnership, gains on sale will be taxed only once, at your personal level—probably at a maximum rate of 23.8 percent or 28.8 percent for gains attributable to real estate depreciation deductions.[4]

Example

Your solely owned C corporation needs a new building.

You set up a single-member LLC owned solely by you to buy the property and lease it to your corporation. After a few years, the property is sold for a $500,000 gain. The entire gain will be taxed on your personal return.

Part of the profit will be taxed at a maximum rate of 25 percent under current law (the part of the gain that's attributable to depreciation deductions). The rest of the gain will be taxed at a maximum rate of 20 percent under current law. You may also owe the 3.8 percent NIIT on both parts of the gain.

Assume you pay a total of $130,000 to the feds for capital gains tax and the NIIT. There's no federal income tax at the single-member LLC level, so your after-tax profit is $370,000 ($500,000 - $130,000). To keep things simple, we will ignore any state income tax hit.

Now let's see what would happen if your C corporation buys the same property.

The $500,000 gain will be taxed at the 21 percent corporate rate under current law. The corporation pays the $105,000 federal income tax bill ($500,000 x 21 percent) and distributes the remaining $395,000 ($500,000 - $105,000) to you. We will ignore any corporate state income tax hit.

The $395,000 will almost certainly constitute a dividend that will be taxed at 20 percent under current law. We assume you'll also owe the 3.8 percent NIIT on the $395,000 dividend. The tax at your personal level is $94,010 ($395,000 x 23.8 percent).

So, you will net only $300,990 after paying federal income taxes at both the corporate and personal levels ($500,000 - $105,000 - $94,010).

Compare the $300,990 with the $370,000 that you would receive under the leased-from-the-single-member-LLC leasing alternative. With the leasing alternative, your after-tax cash is 23 percent higher. That's a big difference in your favor!

Key Point. It's not necessary for assets held by a C corporation to appreciate for double taxation to occur. The conclusion in the preceding example would be the same if the entire $500,000 gain was caused by depreciation (although the tax bill would be a bit higher under the leased-from-the-single-member-LLC alternative due to the 25 percent maximum rate on unrecaptured Section 1250 gains). Depreciation lowers the tax basis of the property, so a tax gain results whenever the sale price exceeds the depreciated basis.

Client Letter on This Article for Use by Tax Pros. Click Here.

1 IRC Sections 301(a); 301(c); 312(b); 316(a).
2 IRC Sections 531-537.
3 Brinks Gilson & Lione A Professional Corporation v Commr., T.C. Memo 2016-20.
4 The maximum federal rate on so-called unrecaptured Section 1250 gains (long-term gains attributable to real estate depreciation) is 25 percent, or 28.8 percent when you tack on the 3.8 percent NIIT.