# C Corporations

BY **MELVIN H. DASKAL, C.P.A., M.B.A.**

**"I am opposed to multi-millionaires, but it would be dangerous to offer me the position."**
**—Mark Twain**

It has been called to my attention, that while I have written entire articles covering S Corporations and Limited Liability Companies (LLCs) — I have only written dribs and drabs, scattered in various articles, about C Corporations. So, we will now dribble all the various drabs into this one article.

## Overview

While all three forms of entities can serve to limit the liability of the owners, the essential difference with C Corporations is in the matter of *taxation* (and then available fringe benefits).

Both S Corporations and LLCs are taxed *as if* they were partnerships, in that there is no federal tax usually levied on the entity. Only the individual owners pay taxes on the net income (as with partnerships). However the C Corporation is subject to "double taxation" to the extent it shows net profits. First, the corporation pays taxes on the net earnings and then the individuals are taxed *again* on any distributions of those net earnings, usually in the form of dividend income.

However, smaller C Corporations pay little or no corporate taxes anyway. Salaries and bonuses to owners and other employees, plus retirement plan contributions, plus fringe benefits (see later) — usually "zero out" all but the larger ones. In that event the C Corporation continues to offer *considerable* advantages over the S Corporation. It probably represents the largest single form of operation of most sales representatives. It's only when the total net earnings become so large (if ever for reps!) that they can no longer zero out as described — and then they usually elect to become S Corporations.

## Why Incorporate?

To reiterate from other articles, a primary reason for incorporation (in either of the corporate forms — or by forming an LLC), is usually to limit the *personal liability* of the owners to the amount they have invested: for the debts, taxes, and other liabilities of the business. It also can provide the owners with a personal shield against product and other liability claims. Generally, shareholders in a corporation are not personally liable for claims against the corporation and are "at risk" only to the extent of their investment in the corporation.

Similarly, the officers and directors of the corporation are not liable for the corporation's debts, although in some cases they may be held liable for failure to withhold and pay over to the IRS the federal income taxes from employees' wages (many states, including California, have similar laws regarding employees' withheld state income taxes — and California also has a comparable rule regarding sales taxes).

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As stated, a secondary reason for incorporation may be to obtain the many fringe benefits that are tax-deductible by the corporation and tax-free to the individual employee (including the owner). In many cases these fringe benefits *cannot be obtained* in the same tax-beneficial manner for S Corporations, LLCs, or for those not incorporated.

### General Characteristics

The chief attributes of any corporation are:

- Perpetual life.
- Limited liability (a big plus these days).
- Centralized management.
- Ease of transferability of stock ownership.
- Title to property can be held by the corporation.
- Your investment is permanent.

### Tax Considerations

As stated, the net income of a C Corporation *may* be subject to "double taxation," in that the corporation first pays federal taxes on that net income at graduated rates of: 15% on the first $50,000, 25% on the next $25,000, 34% on the next $25,000, 39% on the next $235,000, 34% from $335,000 to $10 million (And then 38% and 35% on brackets above — but who cares!). *If* the corporation then declares and pays *dividends* from those earnings, those profits are taxed *again*, as ordinary income to the shareholder. *However*, in many small business corporations, there is usually minimal or no taxable income remaining, as described earlier.

Further, many owners of C Corporations are stunned to learn that if and when they *liquidate* the corporation, the double tax trap hits in full! First the *corporation* pays taxes on any profits from liquidating the assets; then the *owner* pays taxes on a "liquidating dividend" received — to the extent it exceeds the owner's tax basis in the corporation. Sometimes, this is a lotta money.

Alternatively, taxes can be *minimized* by "splitting income" *between* the shareholders/owners *and* the C Corporation — which tactic can keep both sides out of the higher tax brackets. Say the corporation has net profits of $150,000, before the only officer/owner's salary. If a $75,000 salary is paid: the owner is taxed on $75,000 and the corporation is taxed on the other $75,000. Neither is in a very high tax bracket and the working capital of the C Corporation has been increased by the net income retained. Consider this example carefully, since it *only* works for C Corporations.

Even in corporate form, all payroll tax costs can be saved, to the extent legitimate payments are made to the shareholders for *rent* (of a home office) *or interest* (on loans to the corporation) — instead of salary. Additionally, the shareholders can further benefit if they can offset personal interest (i.e., "investment") income with other "investment" expenses. In such cases, you could individually end up with essentially tax-free income *and* your corporation could still get a tax deduction! See your tax advisor for a full explanation of that legal arrangement.

Even C Corporation significant fringe benefits (discussed later) may be a tax motive for incorporation. Some of these "fringes" can be so material in amount that they are taken (particularly by owners) instead of some taxable salary — and most of them *not* similarly available for S Corporations or LLCs.

Dividends received by the C Corporation on stocks it owns of other companies generally receive a 70% federal tax "exemption" — in the form of a deduction from taxable income. This allows accumulation of such dividend income at very low tax rates.

Finally, the continual and horrendous IRS audits of unincorporated (Schedule C) businesses is driving some business proprietors to consider incorporation for that reason *alone*. IRS audits of Schedules C are 4-6 times as frequent as IRS audits of small business corporations! Additionally, the scope and intensity of the Schedule C audit is *much* greater and more difficult (and costly) to handle, than that of a small corporation.

### Whenever You Can — Select a Fiscal (Not Calendar) Year

All regular (C) corporations including sales agencies, (except a special category of "qualified personal service corporations") can select a fiscal year for tax reporting purposes. There are generally tax advantages in doing so, and we virtually always recommend a *fiscal*, rather than a calendar year-end for all C Corporations. For example, this offers the opportunity for a tax-timing difference between the corporation's income and that of the individual owner(s), in that salary may be paid and deducted in one fiscal year or the next — but either is in the *same* calendar tax year of the owner(s).

Consult with your CPA before you make the fiscal year selection, and don't think this is a minor decision. Once you do pick the fiscal year — you *cannot* change it without permission of the Commissioner of Internal Revenue (which is frequently denied).

### Whenever You Can — Use the Cash Method of Tax Reporting!

Whenever possible — the *cash* method of tax reporting should be elected! Usually service businesses (which includes sales reps) can opt for the cash method, as long as their gross receipts average less than $10 million annually; while those eight special personal service categories (and farming corporations), can usually report on a cash basis no matter how high their gross receipts may be. (This special break was put in the law for the particular benefit of the large national CPA firms. As you can see, *they* know the tax benefits of cash basis reporting — so learn from them!).

If inventories are a "material income producing factor," the company may be forced to use the accrual method of tax reporting. But see your tax advisors for certain exceptions. Selecting the cash

method of reporting offers even *more* potential tax-saving advantages than selecting a fiscal year! Which is why the IRS puts all those stated obstacles in your way. Therefore, if you *can* qualify for cash basis reporting — grab it! Again if you are already using the accrual method, you must state your reasons and request permission of the Commissioner of Internal Revenue, to change to the cash method (your chances of approval are generally: "slim or none"). Be sure to tell them the reason for changing is "to pay less taxes" — since that will make a big hit with the IRS (just kidding)! And don't mention my name.

## "Working Condition" Fringe Benefits

This IRS jargon describes what is usually the most significant of all the fully (or mostly) tax-free fringes. To qualify as a working condition fringe, you must meet *all three* IRS requirements:

1. The *employee* would be entitled to a tax deduction for the business expense or depreciation *if* the *employee* had purchased the service or property (which in this case is being provided by the employer).

2. The business use of the service or property must be *substantiated* by adequate records (or sufficient evidence corroborating the employee's own statement).

3. The employee's use of the service or property must be *related to* the employer's trade or business.

**IRS Definition:** "The fair market value of any property or service provided to an employee as a working condition fringe benefit is excluded for income and employment tax purposes to the extent that the costs of the property or services would be deductible by the employee as an ordinary and necessary business expense if he or she *had* paid for the property or services."

Probably the most typical working condition fringes that are familiar to most readers are their employer's payments or reimbursements for *business*: entertainment, travel, auto, telephone and similar.

**WARNING:** Additionally (and quite significantly) the employers providing some (not all) of the fringe benefits, must meet certain *nondiscrimination rules* — in order for those fringes to be tax-free to their "highly compensated" employees and/or owners. Otherwise, they may be tax-free to the rank and file employees, but *taxable* to the highly compensated employees and/or shareholders.

## Fringe Benefits

Consider these fringe benefits, which are generally fully *tax-deductible* by the C Corporation and fully *tax-free* to the individual employee receiving or profiting from the benefit:

- Group medical and dental insurance, which must be non-discriminatory in coverage. You cannot provide greater *benefits* to officers or "highly compensated individuals" than you offer the other employees. However, *higher premiums* paid for older employees are *not* considered discriminatory. The employee is not required to include either the cost of the premiums or the benefits paid by the insurer in his/her taxable income (and dependent coverage is optional and can also be provided tax-free).

- Non-discriminatory Health Reimbursement Arrangements (HRAs) that are fully funded by the employer. They provide a dollar pool for each employee (of the same amount) that they can use to pay medical insurance premiums *and* all other medical expenses. Any amount left over (unspent) for each employee is *carried forward* to increase the maximum amount of reimbursement available for each of them in subsequent years.

- A newer kind of Medical Savings Account (MSA) is available, under certain conditions. To qualify, you must *only* be covered by a *high*-deductible health plan of a small employer (50 or fewer employees). The rules governing this newer type plan are rather complicated. (More than one cynical financial advisor has commented: "Those who need an MSA the most are those who can afford one the least.")

- A written non-discriminatory self-insured (i.e., uninsured) medical reimbursement plan (IRS Sec. 105(b)), which can pay those expenses *not* covered by the group medical insurance — covering employees, their spouse, and dependents. Examples are: the deductible portion of the group medical insurance, the co-insurance percentage portion ("co-pay" in medical insurance jargon) of the group medical insurance, psychiatric, dental (which could include orthodontic work and dental implants), individual's long-term health care premiums (see above), medical transportation, prescription glasses/contact lenses, some laser eye surgery, hearing aids and their batteries — or any other medical expense *not* covered by the group health insurance.

**TAXTIP:** These plans are an alternative to the HRA plans that can also pay all the same items. However the HRA appears much more attractive because of the "rollover" feature.

All these medical arrangements are very attractive, since currently medical expenses cannot be deducted on an individual income tax return, except for any amounts that may exceed 7.5% of adjusted gross income (AGI). These plan options are frequently overlooked and many employees would prefer, $3,000 or $5,000 a year of a medical benefit — to $3,000 or $5,000 of taxable salary (which is a good example of how the later-described corporate "cafeteria" plans also work).

- Disability insurance, which can be bought for only certain individuals, in a discriminatory manner, and in virtually any amount.

**TAXTIP:** When the corporation pays the premiums, if the employee receives disability benefits, they will be *taxable*; while if the employee *personally* pays the premiums, any disability benefits received

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will be *tax-free*. (In favorable IRS Letter Ruling 9741035: the IRS concluded that disability benefits were non-taxable because they were received by the individual *in the year* in which he paid all the premiums — even though the employer-corporation had paid the premiums in an *earlier* year.)

- Accidental death insurance, which can be bought for only certain individuals and in virtually any amount — and the employee can then name the beneficiary. Again not considered discriminatory.
- Coverage under a company-paid qualified long-term care insurance policy can be provided as a tax-free employee benefit. This appears to fall under the same category as a company-paid accident plan (IRC Sec. 7702B(a)(3)). Then, even if the coverage is *discriminatory* — the company can deduct the entire premiums and the employees receive all the benefits tax-free (IRC Sec. 106(a)). Coverage can include both the employee and spouse. This is far better than the same insurance purchased individually, or by other business entities.
- The second idea with this long-term care policy is buy a "front-loaded" policy in which all the premiums are paid (by your C Corporation) *before* you reach age 65. Then, when you retire, there are no further premiums for you to pay personally.
- Up to $50,000 of group-term life insurance coverage for every employee — and the employee can name the beneficiary.

**TAXTIP:** Even on coverage of *more* than $50,000, the amount the employee must report as taxable income for the extra coverage is frequently considerably less than the premium actually paid (and *fully* deducted by the corporation). That's because special IRS tables are used to calculate and report the taxable income — rather than the actual premium on the additional coverage.

- A written, non-discriminatory, "qualified adoption assistance program" that pays up to $10,000 per qualifying child. However, not more than 5% of the total amount paid for such benefits each year can be provided for all the more than 5% company-owners, or their family members.
- Employees can borrow up to $50,000 (or 50% of the equity — whichever is *lower*) from their corporate retirement plan account. The interest they pay on that loan goes back into *their* account, but there are strict IRS rules on timely payment of interest and repayment of principal.
- Each employee can exclude from their income up to $5,000 a year for qualified dependent care assistance programs (however, at least 55% of the average benefits provided must be for *non-highly* compensated employees — and even then, not more than 25% of the amounts paid can be provided for all the more than 5% company-owners, or their family members).
- Company loans of up to $10,000 to any single employee do not *require* that interest is charged or imputed — they can be interest-free, or not, at the option of the employer.
- Educational benefits, such as scholarships or fellowship grants for employees and/or their children, of up to $5,250 a year, per employee. However, not more than 5% of the total amount paid for such benefits each year can be provided for all the more than 5% company owners, or their family members.

**TAXTIP:** For the first time: Graduate level courses can now be covered.

- Education IRAs (IRS Sec. 530) can now be funded by corporations, tax-exempts and other entities, regardless of the entity's income — which offers some creative tax opportunities.
- Flexible benefit/"cafeteria" plans (IRS Sec. 125) that offer the employees a *choice* between taking taxable cash compensation, or a certain "menu" of tax-free fringe benefits (e.g., group: medical, uninsured medical reimbursement plans, dependent care, or life insurance — or a combination of them). The plan must be non-discriminatory and "key employees" may not receive more than 25% of the total benefits.

**TAXTIP:** You can have both an HRA and a Sec. 125 plan as well.

- Company paid parking, or parking allowances, (indexed annually for inflation, in increments of $5).
- *Business* dues (but not "club" dues); plus business subscriptions and publications.
- Discounts on *goods* sold to employees, if the discount is no greater than the gross profit percentage of the company for such items.
- Moving expense reimbursements subject to various limitations.
- "No-additional-cost" *services*, which are defined as services provided to the general public by the company that can also be made available to the employees "without incurring ad-

**"Higher premiums paid for older employees are not considered discriminatory."**

## "It is often said that retirement plans are the "last great tax shelter."

ditional substantial cost." Examples: A CPA firm preparing the tax returns of their employees without charge (we do); free standby flights for airline employees; or free telephone service to phone company employees.

- Up to 20% discounts on other *services* for employees, off the price at which the services are offered to customers.
- Employee gifts up to $25 annually, employee prizes and awards, company parties, holiday gifts, employee eating facility, employee athletic facilities, supper money when working late, occasional tickets to entertainment events, coffee and breakfast snacks, transit passes, moving expense payments, sick pay, etc.
- Computers provided by employers for 100% business use at home.
- Group legal services.
- *De minimus* (i.e., those of minimal value) benefits of property or services (*never* cash) provided to employees. Examples are: occasional meal allowances or local transportation fare when working overtime ("for the convenience of the employer"); employer-provided eating facility; birthday or holiday gifts of property with low market value; coffee, soft drinks, donuts, bagels and similar snacks (Our office kitchen looks like a major restaurant!); occasional theater or sporting event tickets; employee parties and picnics; gifts of flowers, books, fruit and similar (for illness or outstanding performance); group-term life insurance for an employee's spouse or child; local telephone calls; personal use of copying machine; and similar. All providing the employer so chooses — and the nondiscrimination rules do *not* apply.
- Employer-provided special transportation arrangements, for security purposes (because of threats made against the employee or his family members). However, if the threats are from a credit card company that you owe money to — that does not qualify you for this category!
- Business security concerns requiring bodyguard or chauffeur and/or excess transportation costs (see previous).
- Job placement assistance for terminated employees.
- Athletic facilities, including gym, tennis court, or golf course. However, the facility must be: (1) located on the employer's *premises*; and (2) *operated* by the employer; and (3) used *only* by employees and their families — and *not* the general public. (All three conditions must be met.)
- Qualified incentive stock option (ISO) arrangements. A major, *major* benefit in many cases (if the stock goes up).
- Nonqualified stock options, with significantly different tax consequences than an ISO — but also usually very favorable (if the stock goes up).
- Deferred compensation arrangements in which you defer part of your salary in return for the employer's promise to pay at a later date (either unfunded, or preferably, with the funds held in a so-called "Rabbi" trust). The IRS recently tightened the rules on these plans — considerably.
- Retirement planning services to an employee or spouse.
- Any other "working condition fringes" (see definition earlier) that primarily involve the tax-free reimbursement, or direct payment, of all "accounted for" *business* expenses.
- IRS approved "flat" expense reimbursements, such as IRS approved business mileage reimbursements; or the per-diem daily travel reimbursement that covers "lodging, meals and incidentals" (all amounts usually are changed each year); or certain moving expenses. By special exception, these are considered non-taxable "working condition fringes."
- It is often said that retirement plans are the "last great tax shelter." The various corporate retirement plans may represent the biggest benefit of all! The amounts contributed to each plan, up to certain limits, are not only deductible by the corporation and tax-deferred for the employee, but their earnings compound tax-deferred within the plan. When the funds are finally paid out, at your retirement, you are probably in a lower tax bracket (or zero taxes from a Roth 401(k) or Roth IRA distributions).

**TAXTIP:** If you are making considerable profits and you are around age 50 (or older), consider switching to a "defined-benefit" retirement plan, from a "defined-contribution" plan. You could skyrocket the amount of your *own* (legal and tax-deductible) retirement plan contribution.

Now consider these additional benefits and "working condition fringes," which *may* be fully tax-free or sometimes *partially* taxable to the employee. However, they are all highly beneficial to the employee and any taxable income reported by the individual is usually *far* outweighed by the benefits provided:

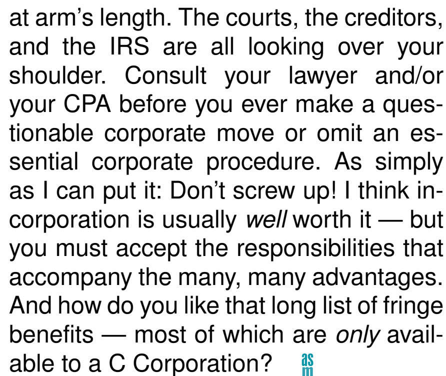
1. Country club memberships, even though "initiation-equity fees" and the club dues are not deductible.

**TAXTIP:** On the corporate books: the initiation-equity fee can be set up as an asset, and the club dues charged to retained earnings.

2. Company-provided autos (despite some "personal use of business auto" income for the individual).
3. Key-person or split-dollar insurance (**CAUTION:** new IRS restrictions on split-dollar insurance).
4. Salary continuation plans.
5. Home computer and home telephone.
6. Employer-provided transportation to and from work.
7. Company trips involving combined business travel and personal vacations.

### Conclusion

For all the advantages of any corporation, you must understand and remember every day: it is a *separate legal entity* that must be dealt with scrupulously and



at arm's length. The courts, the creditors, and the IRS are all looking over your shoulder. Consult your lawyer and/or your CPA before you ever make a questionable corporate move or omit an essential corporate procedure. As simply as I can put it: Don't screw up! I think incorporation is usually *well* worth it — but you must accept the responsibilities that accompany the many, many advantages. And how do you like that long list of fringe benefits — most of which are *only* available to a C Corporation? asm

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