Should you form a C-Corp?

When it comes to choosing the form of your business, some tax pros feel that C corporations have become "the forgotten entity" among entrepreneurs. S corporations, with their easy pass-through of losses and dividends, appeal to many people, and limited liability companies (LLCs) are the cool new kid on the block for owners looking for a simple way to reduce legal exposure. People tend to think of huge businesses like Ford or Boeing or, yes, Microsoft, when they talk about C corporations. But a C corp also can be the right vehicle for small entities. Deducting benefits costs "In my honest opinion, too many people do not take the time to consider the potential advantages of a closely held C corporation," says Mark X. Rigotti, a certified public accountant in Taylor, Mich. I think of Mark as "Mr. C Corp" for the passion he brings to this debate. "The first and most obvious benefit of the C corporation is that the corporation can deduct 100% of the health insurance it pays for its employees, including employees who are shareholders in the corporation. It also can fully deduct the costs of any medical reimbursement plan," Rigotti says. "If you have a small corporation and a lot of medical expenses that aren't covered by insurance, the corporation can establish a plan that results in all of those expenses being deductible." C corporations also can deduct fringe benefits such as qualified education costs, group term life insurance up to $50,000 per employee, employer-provided vehicles and public transportation passes. Note: If you have other employees who are not family members, you'll have to be sure to follow the rules that cover employees under a benefits plan. Better tax treatment A second potential advantage of C corporations is the tax rate applied to modest profits. The first $50,000 in annual profits is taxed at a rate of 15%. By comparison, anyone with taxable income that high is seeing at least part of it taxed at 28%. "The owner of the corporation might receive that profit in salary if the total constituted a reasonable salary," Rigotti says. "But if a profit of up to $50,000 is left in the corporation, you get to take advantage of that 15% rate. This is just a deferral strategy, because eventually you have to deal with taking the money out of the corporation if it continues to be profitable. But we like lower current tax rates when possible." The double-taxation whammy The "deferral strategy" Rigotti refers to leads to one of the potential negatives of a C corporation. If the corporation has profits after paying all of its expenses (including your salary), the corporation pays tax on those profits. When the profits are distributed to you as a shareholder, you pay personal income tax on the dividends. This combination of a corporate income tax, followed by a personal income tax, is commonly referred to as double taxation. Page 2 of 2 Confidential Page 2 8/14/2020 I've seen people go nuts — and I mean absolutely government-is-evil bonkers — at the concept of double taxation. But for many small closely held businesses, double taxation may not be that big of an issue. For openers, many small businesses have little left in the way of earnings after salary and the fringe benefits that I've already outlined are paid out. Little or no earnings mean little or no corporate taxes or doubletaxation issue. Even if there is a dividend, the consequences aren't always financially earth shattering. You'll have to weigh the double-tax issue against many other factors, including the fact that you might be able to delay receiving the dividend and paying the tax on it for several years. I'll give you a warning here, or rather, a whole bunch of warnings: C corporations can be complicated beasts, as can their tax treatment; owners also have to watch out for pitfalls including (but not limited to) the accumulated earnings tax and the personal holding company tax. If you don't know what

these are, then, as they say in the ads, you should consult your tax or financial professional. Losses get held in a C corp and aren't passed through annually to shareholders, which can make other forms — like S corps — more attractive to people who want to claim losses on their personal returns. In addition, tax rates and considerations change rapidly as C corps get more profitable — the marginal rate escalates to 39% at the $100,000-income level. And the IRS has gone after many C corporation employee-shareholders whom the agency felt were taking unreasonably high compensation to try to avoid taxation at the corporate level. As Rigotti says, "A C corporation can require close monitoring by your tax pro."