

Financial, Legal & Tax Advisory

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S-Corporation vs. C-Corporation

It isn't exactly a secret that taxpayers and business owners consistently look to pay as little money as possible to the federal government. Whether they use tax deductions, tax credits, or any other means of reducing their tax burden. For business owners, one way to do this is to evaluate the tax structure of your corporate entity. There are several different options to choose from, such as sole proprietors (where income is reported on an individual's Schedule C) or partnerships (where income is reported on a business' Form 1065. Other individuals, however, may find it more beneficial to elect either S corporation or C corporation status with the Internal Revenue Service to effectively minimize tax burdens.

S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. The shareholders of S corporations then report the flow-through of income and losses onto their personal tax returns, where they are taxed at their individual income tax rates. This gives S corporations the ability to avoid double taxation on their corporate income. S corporations are responsible for tax on certain built-in gains and passive income at the entity level.

One S corporation cannot own another. However, this is a workaround for this. A parent S corporation can use Form 8869 to elect that it treats one or more of its eligible subsidiaries as a qualified subchapter S subsidiary, known as a QSub. C corporations, they operate quite differently. Upon forming a corporation, prospective shareholders will exchange money, property, or both for a share of the corporation's capital stock. A corporation will generally take the same deductions as a sole proprietorship to figure taxable income. When it comes to federal income tax purposes, a C corporation is recognized as a separate taxpaying entity.

A corporation conducts business, has realized net income or loss, paid taxes, and then distributes the profits to the shareholders. All C-Corps will then pay a 21% tax rate on net business income. A double tax comes into play for C corporations because the profit of a corporation is taxed when earned, as well as the profit to shareholders when distributed as dividends. The corporation cannot take a tax deduction when it distributes dividends to shareholders. Along with this, the shareholders cannot deduct any losses of the corporation. Since the 2017 Tax Cuts and Jobs Act was signed into law, C corporation taxes are a flat 21%. Individual federal income tax rates can go as high as 37%.

Another change with the 2017 tax law is that owners of pass-through entities like S corporations may be able to deduct 20% of the business income from their individual tax returns. C corporation owners are not afforded that luxury. Although C corporations and S corporations operate very differently, they are both still required to file a federal income tax return. C corporations use Form 1120, while an S corporation while use Form 1120S. An S corporation must also prepare K-1's for each shareholder to include within their individual returns.

In a preventative effort to eliminate tax avoidance schemes, the IRS states that distributions to S corporation shareholders "must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation." In short, S corporation shareholders cannot take dividends in place of a salary to avoid payroll taxes. This is an area where S corporations are heavily audited. If you happen to own or plan on owning a small business, reach out to the professionals at The Center for Financial, Legal, and Tax Planning by contacting us online at www.taxplanning.com or calling us at (618) 997-3436.

Basi, Basi & Associates at The Center for Financial, Legal, & Tax Planning, P.C.

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