



# Corporate Tax

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## Background

There are four basic types of business entity:

1. CORPORATIONS (C and S)
2. Limited liability companies
3. Partnerships (general and limited)
4. Sole proprietorships

Basically, if someone is the only owner of a business, that person will be able to form any of the types except a partnership. If there are two or more owners, they will be able to form any business type except a [SOLE PROPRIETORSHIP](#). Tax law is a large and complicated subject.

## How Corporations Are Taxed

Corporations are taxed in a different manner than other business entities. In fact, corporations are the only types of business that pay income taxes on their profits. Conversely, partnerships, sole proprietorships, and limited liability companies (LLCs) are not taxed on business profits. Rather, the business profits "pass through" to the business' owners, who in turn report the business income (or losses) on their personal [INCOME TAX](#) returns.

Corporations are taxed separately from their individual owners. If a taxpayer's business is not incorporated, all the profits from the business will be taxed on the taxpayer's personal income [TAX RETURN](#) in the year that the profits were earned. Incorporating such a business may prove to be a good way to save on taxes, especially if the taxpayer intends to reinvest the profits in the business. For example, if a taxpayer's business is incorporated, the first \$75,000 of the business's profits will be taxed at a lower rate than if the taxpayer claimed them on his or her personal income tax return. However, there are exceptions: personal service corporations like legal, accounting, consulting, and medical groups must pay a flat tax rate of 35 percent on their [TAXABLE INCOME](#).

Corporations can deduct employee benefits, such as health insurance, [DISABILITY](#), and up to \$50,000 in life insurance. This [DEDUCTION](#) applies to owners who are also employees of the company. The **IRS** permits incorporated businesses to treat their owners as employees for benefits purposes, allowing these owners to

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take the tax deduction on their own as well as their employees' benefits. Conversely, owners of unincorporated businesses and sole-proprietorships cannot deduct their own benefits.

Taxpayers cannot immediately claim on their personal income tax [CORPORATE](#) losses on their incorporated businesses. Rather, they must wait until they can offset their losses by profits. This is particularly problematic for newer businesses because most new businesses produce very little revenue in their first few years and losses are common.

### ***Corporate Tax Payments***

Corporations must file corporate tax returns every year. They are taxed on their profits at a corporate income tax rate. If a corporation expects to owe taxes, the IRS requires it to estimate the amount of tax due for the year and make payments to the IRS on a quarterly basis—in the months of April, June, September, and January.

### ***Shareholder Tax Payments***

If the corporation's owners work for the corporation, they will pay individual income taxes on their salaries and bonuses, just like regular employees of any business. Salaries and bonuses are [DEDUCTIBLE](#) business expenses to the corporation, so the corporation can deduct those costs and does not pay taxes on them.

### ***Dividends***

For corporations that distribute dividends to its owners, the owners must report and pay personal income tax on these amounts. Dividends are not tax-deductible, unlike salaries or bonuses. Moreover, the corporation must also pay taxes on dividends. Thus, dividends are taxed twice—once to the corporation and again to the shareholders.

### ***Retained Earnings***

Corporations frequently want or need to retain some of their profits at the end of the year. These funds can be used for a wide range of business activities such as expansion, development, or other purposes related to growth in the business. If the corporation does retain some of its profits, the corporation will be liable for taxes on that money at the appropriate corporate income tax rate. A corporation's owners can save money by retaining a portion of corporate profits in the company because the initial corporate income tax rates are lower than most owners' marginal income tax rates for the same amount of income. In contrast, owners of sole proprietorships, as well as partnerships and LLCs, are taxed on all business profits at their individual income tax rates, whether they take the profits out of the business or not.

The IRS permits corporations to retain a limited amount of profits within the corporation. Most corporations can legally retain up to \$250,000 at any one time in the corporation without facing negative tax consequences. There is an exception for some professional corporations that may not retain more than \$150,000.

### ***Fringe Benefits***

C corporations can deduct the full cost of the fringe benefits it provides to its employees—including the business's owners in most instances. This factor provides shareholders of C corporations with a slight advantage over other types of business owners because owners of limited liability companies, partnerships, and sole proprietorships may not take as many fringe benefit deductions. For example, sole proprietors, owners of partnerships, and LLCs cannot currently deduct 100 percent of their health insurance premiums (although the limit increases by increments through 2003 until these other businesses will be able to deduct

the full cost of their health insurance premiums).

As we have seen, corporations are separate entities from their owner-shareholders. They are established as either C corporations or as S corporations (sometimes known as subchapter S corporations), and the tax laws apply to each of these differently.

### ***Tax-Deductible Expenses***

To help offset taxable profits, a corporation can deduct its business expenses. These include basically any money the corporation spends in the ordinary and legitimate pursuit of profit. Some of the principal business deductions include:

- Costs associated with medical plans
- Ordinary operating expenses
- Product and advertising outlays
- Retirement plans for employees
- Salaries and bonuses
- Start-up costs

## **C Corporations**

C corporations are formed when corporations are created. If those forming the corporation do not elect to be treated as an [S CORPORATION](#), their corporation will continue to be a C corporation. Like other business entities, C corporations are taxable entities and file tax returns (Form 1120). They pay tax on [NET](#) profits each year. Any profits remaining after taxes can be distributed to the shareholders as dividends.

### ***Tax Advantages of C Corporations***

In many instances, C corporations can be more flexible than S corporations. For example,

- Owners of C corporations can choose a [FISCAL](#) tax year
- C corporations are not limited to the numbers or types of shareholders
- C corporations can deduct contributions to charities. Other types of business entities must pass charitable expenses through to the owners, who then might be able to deduct them on individual tax returns
- Until recently, C corporations enjoyed the most options in choosing retirement plans

Because of this flexibility, C corporations are the entity of choice for most tax-free mergers and acquisitions

### ***Tax Disadvantages of C Corporations***

Perhaps the most significant tax disadvantage for owners of C corporations is that these entities have a form of double [TAXATION](#). The corporation itself is taxed, as are the dividends it earns. These taxes are collected before the shareholders receive their aftertax shares of the profits. This is the main reason that many people choose to create a different kind of business entity such as an S corporation or a partnership.

There are three other significant tax disadvantages to C corporations:

1. If there is any taxable gain from the [LIQUIDATION](#) or sale of corporate assets, there will also be

double taxation to the shareholders

2. In terms of special allocations of profits or expense items, C Corporations are less flexible than partnerships
3. Losses to the corporation cannot be passed through to the shareholders

## **S Corporations**

At its foundation, an S corporation is a C corporation that has elected to be taxed as a "pass through" entity. The election is made on Form 2553 and must be filed with the IRS no later than 60 days after the beginning of the year in which the election is to be effective. The election is revocable. Once the business owners have made the election, it remains in effect until the business's owners revoke it. Instead of being taxed on its income, the S corporation passes the income through to the shareholders, where it is taxed as part of their personal income. S corporations file Form 1120S, a different return from that used by C corporations.

### ***Tax Advantages of S Corporations***

In the most basic sense, S corporations do not pay taxes on income. Rather, income, losses, deductions, and credits pass through the corporations to shareholders. S corporations provide shareholders with liability protection that comes with being incorporated, yet business profits and losses pass through to the owner's personal income tax returns.

S corporations can be an especially good idea for start-up companies. For example, if new businesses sustain losses in some years, their owners can claim those losses in the current year of the loss on their personal tax returns.

There are other benefits to electing to be taxed as an S corporation. For example, if a taxpayer incurs interest in order to purchase S corporation stock, the taxpayer may deduct that interest as an investment interest expense. And when selling an S corporation business, the owners' taxable gain on the sale may be less than it would be if the business had been a C corporation.

The IRS permits most but not all small businesses to incorporate as S corporations. In order for a small business to qualify for S corporation status, the business must meet these three requirements:

- It must be a U. S. company
- It must have only one class of stock
- It must have no more than 75 shareholders, all of whom must be legal residents or U. S. citizens and not also part of partnerships or other corporations

The tax reporting rules for S corporations are similar to those of partnerships. However, the IRS treats shareholders of S corporations as employees for payroll tax purposes. An S corporation must provide its employees a Schedule K-1, which lists the relative share of income or loss, deductions, and credits that must be reported on the employees' income tax returns. And the IRS treats health insurance premiums paid by an S corporation for more than 2 percent stockholders as wages; these are deductible on Form 1120S by the corporation and reported to the stockholder on Form W-2.

However, there are limitations on deductions. For example, taxpayers may only deduct losses in the same amount that they put into their companies on their personal tax returns. Additionally, there is potential for problems when it comes to claiming losses from passive activities if taxpayers do not actively work in the taxpayers' S corporation. These can only be used to offset passive income.

### ***Tax Disadvantages of S Corporations***

S corporations are less flexible than partnerships in terms of allocating profits and expenses for tax advantages. Also, if an S corporation liquidates an asset, it can result in taxable gain for its shareholders.

Other issues associated with S corporations that give rise to tax disadvantages include the following:

- **Accounting:** Accounting rules that apply to S corporations can be extremely complex which can result in higher accounting and tax preparation fees for S corporations
- **Complex tax preparation:** Tax preparations and filing become complicated when an S corporation has out-of-state shareholders or conducts business in multiple states. Shareholders who live in states other than the one in which the corporation is located must file tax returns in their home states, as well as filing in the state or states in which the business is located. If an S corporation conducts business in multiple states, each shareholder may have to file tax returns to each of the states in which the corporation does business
- **Minimum tax:** Tax preference items reported on shareholders' personal income tax returns can trigger an unexpected minimum tax problem for some.
- **Recognition:** Not all states recognize the S corporation as a legitimate business entity
- **Salaries for shareholders:** The IRS watches closely the salaries of shareholder-employees. If warranted, it may claim that the corporation is underpaying its shareholders to save in paying FICA taxes

### **Corporate Tax Credits**

In most cases, tax credits for corporations are more beneficial than deductions. The amount of tax credits remains constant regardless of the income level and tax bracket of a corporation. By contrast, the amount of money a taxpayer actually saves through deductions depends to a great extent on the taxpayer's income level and tax bracket. For example, one company with the same amount or type of deduction as another corporation may end up with a larger or smaller deduction than the first corporation because of the relative tax brackets of the individual businesses. Additionally, tax credits reduce a taxpayer's taxes more than a tax deduction of the same amount. Thus, tax credits are almost always more beneficial to taxpayers.

Some of the credits that may be available to corporations are as follows:

- **Credit for federal tax on fuels used for certain purposes:** Taxpayers may claim this credit when they have paid tax on nontaxable forms of aviation fuel or gasoline, diesel fuel, gasohol, gasoline, kerosene, and liquefied petroleum gas
- **Credit for prior year minimum tax:** Corporations can claim this credit to figure the minimum tax credit if any for the alternative minimum tax they incurred in previous tax years and to figure any minimum tax credit to carry forward
- **Foreign tax credit:** When a foreign country or a U. S. possession imposes a tax upon the income or profits of a U. S. domestic corporation, the corporation can claim a credit for those foreign taxes it paid
- **Possessions tax credit:** Corporations may take this credit when the corporation uses the profit split method or the cost sharing method of computing taxable income for a particular product
- **Qualified electric vehicle credit:** Corporations may claim a tax credit for a qualified electric vehicle it places in service during the tax year. The corporation can make this choice regardless of whether the vehicle is used in a trade or a business

In conclusion, reporting and paying taxes on a separate corporate tax return can be time consuming. However, it is clear that there are some real benefits to having a separate level of taxation. Taxpayers should consult a tax expert for a complete explanation of corporate taxation as it applies to their situations.

## Additional Resources

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"United States Tax Court" United States Tax Court, 2002. Available at <http://www.ustaxcourt.gov/>.

## Organizations

### *Council on State Taxation*

122 C Street, NW, Suite 330 NW  
Washington, DC 20001-2109 USA  
Phone: (202) 484-5222  
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URL: <http://www.statetax.org/index.html>

### *Federation of Tax Administrators (FTA)*

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URL: <http://www.taxadmin.org/>

### *National Tax Association (NTA)*

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### *U. S. Chamber of Commerce*

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