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FROM THE LAW OFFICE OF MARY HANSON

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About the BusinessAdvisor

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She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

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THE TROUBLE WITH C CORPORATIONS

by Mary Hanson

Potential tax pain often lurks quietly in businesses operated as C corporations until the C corporation has been in business for a number of years. Since a C corporation is a separate taxpayer and not a "pass through" entity, a C corporation can build up gains or losses and then spring a nasty tax surprise on an unsuspecting business owner. Whether the C corporation has been operating at a profit, a loss, or break even, the sale of an asset owned by the corporation, the sale of the business, or the closure the business often reveals the disadvantages of operating as a C.

What Are the Problems with C Corporations?

- A C corporation is a separate taxpayer, paying taxes on its own income and gains. Its profits are not taxed to its shareholders, and its losses are not passed on to its shareholders.
- When a C corporation sells its assets it must pay tax on its gain (the difference between the tax basis of the assets held by the corporation and the purchase price paid for the assets).
- C corporations pay taxes at ordinary corporate rates on capital gains.
- When a C corporation dissolves and distributes its assets to its shareholders, the shareholders pay capital gains taxes on the amount they receive minus their tax basis in their stock (a second layer of tax after the corporation pays its taxes).
- Distributions of profits to shareholders are taxable to the shareholders as income but not deductible to the corporation.
- The 3.8% Net Investment Income tax imposed by a new federal tax law in 2013 applies to dividends paid by a C corporation to shareholders and to gain on sale of C corporation stock.
- When a C corporation dissolves or otherwise terminates, any unused losses held by the corporation lose their usefulness. Only future income of the C corporation can offset and utilize the losses.
- A C corporation's losses cannot be used to offset gains by its shareholders. Losses built up in a C corporation can be used to offset future income of the corporation (reducing its taxes), but can rarely otherwise benefit the shareholders, future shareholders, or purchasers of the business.
- A C corporation's losses are rarely transferable (such as to a buyer of the business or buyer of the corporate stock).
- A C corporation's losses are lost upon conversion of the corporation to S corporation status.

Problems When the C Corporation Generates Significant Profits

While the business of a C corporation is operating normally, the corporation and its shareholders often avoid two levels of tax by having the corporation pay

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"If a C corporation terminating its existence has losses that it has not been able to use, those losses are 'lost.'"

out profits as bonuses (employment compensation) to the shareholders employed by the corporation, rather than distributing profits as dividends to the shareholders. This works adequately so long as the profits are not very high and all the shareholders are employed by the corporation.

When the profits of a C corporation are high or when the shareholders do not all work for the corporation, the practice of bonusing out profits doesn't work well. The IRS might challenge the compensation to the employed shareholders as excessive compensation – and so might the non-employed shareholders. The IRS might challenge the corporation seeking additional taxes, interest and penalties. Other shareholders might pursue the compensated shareholders seeking distribution of dividends or other benefits.

C corporation shareholders sometimes seek to avoid the two levels of tax by making investments at the corporate level, using the C corporation profits to purchase real estate or other investments to be held by the C corporation. This approach exacerbates the problem of value accumulating in the corporation, by increasing the assets subject to the two levels of tax.

C corporation shareholders will encounter the negative consequences of this approach if they ever wish to sell a valuable corporate asset to meet personal needs. The sale, for example, of real estate used by a C corporation is likely to result in a surprisingly high total tax. The corporation's taxable gain will be high if over the years the tax basis was reduced by depreciation taken while the market value of the property increased.

Corporations are not entitled to a lower capital gains tax, and the gain from the sale of an asset is added to the corporation's other taxable income for that year. The transfer of funds to the shareholder is taxable to the shareholder, whether treated as a dividend or compensation. If there is just one shareholder, he or she might have the power to use timing and tax treatment to minimize the tax burden, by spreading payments over more than one tax year, taking funds as a qualified dividend rather than compensation, and keeping payments low to avoid the threshold for the 3.8% NII tax.

Problems When the Business is Sold

The result of the sale of assets and dissolution of a C corporation is particularly painful. Most buyers insist on purchasing a business as an asset purchase, not a stock purchase. They do not want to pick up liabilities as well as assets by acquiring an entire corporation.

The taxes at the C corporation level are on the difference between the tax basis of all the assets sold by the corporation and the sale price received by the corporation. The taxes at the shareholder level are on the difference between all the remaining corporate assets or funds distributed to the shareholders and the shareholders' tax bases in their stock.

The tax consequences of the sale of a business operated as a C corporation are the same as those described above where a shareholder needed funds generated by the sale of a corporate asset. But the sale of a business is even more painful, since all the assets of the corporation are typically sold in one

transaction and since the managers and shareholders are more constrained in their options for minimizing the tax burden. One reason is that the structure of a sale will be determined by negotiations with the buyer. Another is that in the liquidation of the corporation after selling all the assets, liquidating dividends must be distributed pro rata according to share ownership, limiting timing and structure options that might have been beneficial to some shareholders.

In addition, when a C corporation sells all its assets and ceases to do business, the music stops (or the tide goes out, depending on which metaphor you prefer for being forced to face reality). The corporation and shareholders can no longer defer the tax consequences of building up gains (or losses) over the years.

Can Two Levels of Tax be Avoided?

The two levels of tax (and in particular the high corporate capital gains taxes) can be avoided by structuring a business sale as a sale of the C corporation stock. When shareholders sell their stock there is only the one level of tax – the shareholders' taxes related to the sale of shares of stock.

Since buyers are reluctant to purchase stock and get stuck with corporate liabilities as well as assets, sellers need to consider other ways to change the tax consequences. If the corporation has just one shareholder who is also a key employee, the buyer and seller can agree that more compensation will be paid directly to the individual, as, for example, employment or consulting compensation or payment for a covenant not to compete, rather than payment to the corporation for assets. If a shareholder personally owns equipment, real property, or intellectual property needed by the buyer, there are additional opportunities to pay the individual rather than the corporation. Buyers often benefit from making payments direct to the individual, since compensation, lease payments, and licensing fees are readily deductible by the buyer, so that the buyer's tax deductions are better than the deductions from the purchase of assets from the C corporation.

If the C corporation is owned by a number of shareholders with different levels of involvement, this approach may not be workable. But if the facts support the payment of compensation to individuals, the tax burden can be reduced in a way acceptable to buyers and sellers.

Problems When the Business is Closed

When a C corporation ceases doing business there are still two levels of tax on the disposition of assets by the corporation and then the distribution of funds to the shareholders. Closing a business is essentially the same as the sale of a business as an asset sale – at a lower price for the assets. The closure doesn't generate much of a tax at the shareholder level if the funds generated by the liquidation of assets equal the corporation's obligations. But a C corporation can still cause two levels of pain.

If a C corporation terminating its existence has losses that it has not been able to use, those losses are "lost." Without future income against which to offset the losses, the C corporation (and its shareholders) typically get no benefit from the years of operating at a loss.

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Publisher's Note

Tax law is much more complex than presented in this article. There are requirements, limitations, qualifications, exclusions, floors, ceilings, and much, much more that affect how the general points discussed here might affect a particular situation. This article is intended to raise awareness of tax laws that frequently cause pain to C corporations and their shareholders. Every business needs its own careful, detailed, and knowledgeable tax advice based on its particular circumstances. At the shareholder level, each shareholder also has his or her own personal tax circumstances which may differ significantly from other shareholders in the same corporation.

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Attorney/Publisher

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The shareholders cannot normally transfer the accumulated losses by transferring the shares to a buyer who would like to utilize the losses. The termination of the activities of the C corporation's business normally puts an end to the ability to utilize the losses carried forward from previous years.

If the corporation's operating losses were covered with additional shareholder investment or shareholder loans, shareholders may find that the C corporation can impose pain when there are losses as well as when there are gains.

Because of tax law requirements and limitations relating to shareholder investment and shareholder loans, shareholders may find that they not only are not repaid their investments or loans, but that they also are prevented from writing off those losses.

Can a C Corporation Convert to an S Corporation and Avoid the Two Levels of Tax?

No. A C corporation cannot elect S corporation status and avoid its problem of double taxation. Tax regulations subject a C corporation to additional taxes at the time of a conversion to S corporation status and also over 10 years following the conversion. A change of status from a C corporation to an S corporation needs to be carefully planned and all short term and long term tax consequences of such a change must be calculated by a tax professional experienced in such conversions. A conversion can be made, but it is unwise to do so without a complete picture of the consequences of the change. BA