S Corporation vs. C Corporation

Factors to Consider

Income tax:

S Corporation. Income passes directly to shareholders.

C Corporation. Income is taxed first at the corporate level, then taxed again at the individual level when distributed as dividends.

Top tax rate:

S Corporation. 39.6% (top individual rate for 2015).

C Corporation. 35% for 2015 (39% at certain taxable income levels).

Bottom tax rate:

S Corporation. Graduated rates for individuals begin at 10%.

C Corporation. The tax rate is 15% for the first $50,000 of taxable income regardless of the shareholder's income.

Undistributed earnings:

S Corporation. Since taxable income passes through to shareholders without regard for whether distributions are made, subsequent distributions of profits from an S corporation generally are not taxable, up to the shareholder's basis.

C Corporation. Undistributed earnings in a C corporation may be eligible for capital gains tax rates when the corporation is sold.

Fringe benefits:

S Corporation. Restrictions for shareholders who own more than 2% of the corporation's stock.

C Corporation. Few restrictions.

Dividends/Capital Gain vs. Ordinary Income

The maximum rate for qualified dividends from C corporations is 15% for most taxpayers (highest bracket individuals pay 20% on qualified dividends) [IRC §1(h)(11)], but S corporation income is taxed at ordinary rates.

Because of the reduced rate for C corporation dividends, in some cases taxes on a C corporation's profits may be less than those on an S corporation's, depending on the marginal tax rates of the corporation and the shareholders.

Example #1: Cal and Rex are each 50% shareholders in CalRex, Inc., a C corporation. The shareholders decided to do a tax projection assuming current rates continue in future years to help decide whether to change to S corporation status. Cal's marginal individual income tax rate is 28%, and Rex's is 35%. The corporation distributes profits evenly between the shareholders.

C Corporation		*S Corporation*	
Corporate profit	$ 100,000	Corporate profit	$ 100,000
C corporation tax	< 22,250 >	Flow through to each shareholder	$ 50,000
Dividend distribution	$ 77,750		
Dividends—Cal	$ 38,875		
Dividends—Rex	$ 38,875		
Cal's tax[1] [($38,875 × 15%) + ($22,250/2)]	$ 16,956	Cal's tax (28%)	$ 14,000
Rex's tax[1] [($38,875 × 15%) + ($22,250/2)]	$ 16,956	Rex's tax (35%)	$ 17,500

If the corporation elects S status, Cal saves $2,956, and Rex loses $544.

[1] Including half of the C corporation tax.

Example #2: Ben owns 100% of WRT, Inc., a C corporation. WRT has earnings of $50,000 per year. Ben plans to sell the corporation in two years and is considering converting to S status. Assume that Ben's tax rate is 39.6% for both years (20% for dividends and capital gains).

C Corporation Distributes Profits as Dividends:		
Accumulated C corp. earnings for 2 years	$ 100,000	
Accumulated C corp. tax (15%) for 2 years		$ 15,000
Tax on dividends [($100,000 - $15,000) × 20%]		17,000
NII Tax (3.8%)		3,230
Total tax		$ 35,230
C Corporation Retains Earnings:		
Accumulated C corp. tax (15%)		$ 15,000
Ben's capital gain tax at sale [($100,000 - $15,000) × 20%]		17,000
NII Tax		3,230
Total tax		$ 35,230
S Corporation Profits Passed Through:		
Total tax ($100,000 × 39.6%)		$ 39,600

Ben will pay the least tax by keeping C corporation status, assuming dividends and capital gains are both taxed at a maximum rate of 20%.

Observation: The income tax results with a C versus an S corporation will vary with the shareholder's level of income and tax rates.

Example #3: Ralph owns 100% of ElePantz, Inc., an S corporation. Because of the current low tax rates for C corporation dividend distributions (which Ralph expects to continue for several years). Ralph considers revoking his S corporation status and becoming a C corporation. Ralph's accountant prepares tax projections of a C corporation as compared to an S corporation, assuming four different levels of corporate income. Ralph's wages from ElePantz total $60,000 each year. All corporate profits will be distributed to Ralph as dividends. Ralph is single and has no other income. The calculations support retaining the S corporation status.

C Corporation	**Example A**		**Example B**		**Example C**		**Example D**	
Taxable income		$ 10,000		$ 30,000		$ 60,000		$ 100,000
Corporate tax		$ 1,500		$ 4,500		$ 10,000		$ 22,250
Individual tax[1]								
Wages	$ 60,000		$ 60,000		$ 60,000		$ 60,000	
Qualifying dividends[2]	8,500		25,500		50,000		77,750	
AGI	$ 68,500		$ 85,500		$ 110,000		$ 137,750	
Itemized deductions	< 12,000>		< 12,000>		< 12,000>		< 12,000>	
Exemption	< 4,000>		< 4,000>		< 4,000>		< 4,000>	
Taxable income	$ 52,500		$ 69,500		$ 94,000		$ 121,750	
Income tax		$ 8,069[3]		$ 10,619[4]		$ 14,294[5]		$ 18,457[6]
Overall tax—C corporation		$ 9,569		$ 15,119		$ 24,294		$ 40,707
S Corporation								
Corporate tax		$ 0		$ 0		$ 0		$ 0
Individual tax**1**								
Wages	$ 60,000		$ 60,000		$ 60,000		$ 60,000	
S corp income (from K-1)	10,000		30,000		60,000		100,000	
AGI	$ 70,000		$ 90,000		$ 120,000		$ 160,000	
Itemized deductions	< 12,000>		< 12,000>		< 12,000>		< 12,000>	
Exemption	< 4,000>		< 4,000>		< 4,000>		< 4,000>	
Taxable income	$ 54,000		$ 74,000		$ 104,000		$ 144,000	
Income tax		$ 9,294		$ 14,294		$ 22,191		$ 33,391
Overall tax—S corporation		$ 9,294		$ 14,294		$ 22,191		$ 33,391

Tax savings as S corporation	$ 275	$ 825	$ 2,103	$ 7,316

[1] Using 2015 individual rates and exemption amount

[2] Taxed at 15%

[3] ($8,500 × 15%) + $6,794

[4] ($25,500 ×15%) + $6,794

[5] ($50,000 ×15%) + $6,794

[6] ($77,750 × 15%) + $6,794

Planning Tips

- Corporations that distribute most or all profits to shareholders may consider electing S status to avoid double tax on profits. Corporations that retain most or all profits may pay tax at a lower rate by remaining a C corporation.
- If net operating losses (NOLs) are anticipated, S status will allow the NOL to pass through so shareholders can potentially realize a current tax deduction on their individual returns.
- If a C corporation has large NOL carryovers, electing S status can cause loss of the NOL deduction. An NOL carryover cannot be used in an S status year, but the clock still runs for purposes of the Section 172(b) 20-year carryover limit.
- In a C corporation, earnings can be retained and distributed in later years when the shareholder may be in a lower tax bracket. Earnings may also be distributed as capital gains in a qualifying stock redemption. If the shareholder dies before the retained earnings are distributed, the person who inherits the stock will receive the higher fair market value (FMV) (which includes the retained earnings) of the stock as his basis.
- In a liquidation, the C corporation pays a tax on the appreciated value of its assets, and the shareholders pay tax on the appreciated value of their stock. An S corporation generally avoids the double tax because the gain on the appreciated value of the assets increases the shareholder's basis in stock.
- Certain C corporations must convert from the cash method to the accrual method. By electing S status, this may be avoided. See *Accounting Methods*.
- S corporations have certain restrictions in choosing a fiscal tax year. C corporations generally are not so restricted.
- S corporations are not subject to alternative minimum tax.
- S corporation shareholders may be subject to the passive loss rules. C corporations can sometimes offset passive losses against nonpassive income (if they are not closely held or personal service corporations).