



C Corporations

Tax and Business Update

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Reasons to Incorporate

Nontax reasons:

- Asset protection.
- Continuity of life for business entity.
- Transferability of ownership interests.

Tax reasons:

- Income splitting and tax rates.
- Fringe benefit rules.
- Employment tax reduction.
- Tax year rules.
- Tax-free reorganizations.
- Tax benefits of employee stock ownership plans (ESOPs).
- Qualified small business corporation (QSBC) tax rate and gain rollover rules.
- Passive activity loss rules.
- Dividends received deduction.
- Multiple corporation benefits.

Corporate Distributions

- 1) *Amount of Distribution.* Equals the cash plus the value of any property (reduced by attached liabilities) included in the distribution.
- 2) *E&P and Basis.* Shareholder has a taxable dividend to the extent the distribution is paid out of current or accumulated earnings and profits (E&P). If it exceeds E&P, the excess reduces the shareholder's stock basis. Any amount in excess of basis is capital gain.
- 3) *Stock Redemptions.* Treated as either a nonliquidating corporate distribution (potentially a dividend) or proceeds from selling the shares back to the corporation (capital gain or loss).

Segregating Activities in Multiple Corporations

<p>Limiting Liability</p>	<p>Critical in businesses with a high risk of lawsuits (oil and gas drilling, transportation of hazardous material) or requiring substantial financing (real estate development).</p>
<p>Insulating Low-Risk Assets From High-Risk Assets</p>	<p>If multiple assets or activities are owned by one corporation, it may be advisable to form separate corporations to insulate the assets of one operation from potential lawsuits or loss by the high-risk activity of another. (Also, a creditor or major supplier occasionally prefers that different operations be separately incorporated.) For example, a corporation owns \$500,000 of securities, an operating business and land. The securities are exposed to the debts arising from the business and land.</p>
<p>Hollowing Out an Operating Company Using Multiple Entities</p>	<p>To protect business assets, consider hollowing out the business by dividing it into two separate entities: an operating one and an asset-owning one. The operating entity provides products/ services to the public and has contractual dealings with suppliers, purchasers, employees, etc. These activities create significant liability exposure, particularly for professional practices and high-risk businesses. There is little risk in owning equipment and leasing it to a sister company. Given the choice, it is beneficial to place all valuable assets in the asset-owning corporation and retain minimal capital in the operating one. The operating entity can lease necessary equipment from the asset-owning one without exposing the equipment to its own creditors.</p>

Caution: A thin (undercapitalized) corporation is subject to being pierced as a mere shell. Accordingly, it is important that any limited liability entity be sufficiently capitalized to carry out its operations. State law and the corporation's facts and circumstances (for example, the type of business it operates) are key factors to determine the minimum capital required. Owners should consult a local attorney for advice on the appropriate capitalization in their state.

Dividend Planning Ideas

Paying dividends to low-bracket shareholders.

The American Taxpayer Relief Act of 2012 made the 0% and 15% tax rates on qualified dividends permanent for most taxpayers. Beginning in 2013, the tax rate is (1) 0% for taxpayers with a marginal tax rate on ordinary income of 10% or 15%; (2) 15% for taxpayers with a marginal tax rate on ordinary income of 25% or greater whose taxable income falls below the levels for the 39.6% regular tax rate (MFJ or QW—\$450,000; HOH—\$425,000; Single—\$400,000 and MFS—\$225,000) and (3) 20% for taxpayers with taxable income above those levels. An additional 3.8% tax on net investment income may also apply at the shareholder level, effectively raising the tax rate on qualified dividends for higher income individuals to 18.8% (15% + 3.8%) or 23.8% (20% + 3.8%).

Distributing appreciating assets to shareholders.

While this can trigger double tax, the preferred rate on qualified dividends reduces the tax burden. Consider distributing appreciated corporate assets, especially when the corporation has losses to offset its gain triggered by the distribution. Also consider distributing assets that haven't yet appreciated much, but that are likely to. Getting assets out of the corporation now can prevent a large future tax bill on the appreciation.

Compensation Planning Tips

To increase likelihood that employee/shareholder pay is deductible:

- 1) *Consistently Apply Formal Compensation Policies.* Formalize in writing and apply consistently from year to year.
- 2) *Use Objective Third Parties to Determine Compensation.* Using professional advisors or outside directors to design shareholder/employee compensation packages shows objectivity and reasonableness. Ensure the advice is well documented.
- 3) *Document the Rationale Behind Compensation Decisions in the Corporate Minutes.* The corporate minutes should reflect compensation for each shareholder/employee and the rationale supporting the compensation.
- 4) *Use Reliable Data for Comparable Companies.* Favorable data on comparable salaries should be collected for documentation. Compensation decisions should be in line with appropriate industry averages unless there are factors justifying the difference (in which case the factors should be set forth in writing, preferably in the corporate minutes).

- 5) *Anticipate Steady (Not Explosive) Growth in Compensation.* When possible, plan for steady growth of compensation. It is more difficult to defend explosive growth in compensation from one year to the next (unless the employee was clearly undercompensated in earlier years, which should be documented in the corporate minutes).
- 6) *Do Not Use Compensation as a Tool to Erase Corporate Earnings.* Salary and bonuses of shareholder/employees should not be blatantly designed to wipe out corporate earnings each year. This violates the concept that a company's return on equity should be at a level an outside investor would accept. (The company's retained earnings generally should grow). But for professional service firms where all income comes from the shareholders' work, zeroing out earnings may be acceptable.
- 7) *Pay at Least Nominal Dividends.* Compensation payments are often easier to defend if at least some dividends were paid.
- 8) *Avoid Compensation Payments Proportionate to Stock Ownership.* Compensating shareholder/employees based on their stock ownership indicates that at least part of the compensation package is disguised dividends.
- 9) *Use Fringe Benefits and Deferred Compensation.* Establishing fringe benefit and deferred compensation plans can compensate shareholder/employees with less "visibility" than salaries and bonuses. While relevant to determining reasonableness, they may reduce the likelihood of an IRS challenge.
- 10) *Pay Shareholder/Employees in Relation to Their Contributions to Company Success.* Compensation is not the place to equalize active and inactive family members. (Gifts, including stock gifts, are better suited.) Paying productive shareholder/employees more is easier to defend than claiming compensation deductions for payments to nonproductive family members.

The information contained in this handout was not intended or written to be used and cannot be used for the purpose of (1) avoiding tax-related penalties prescribed by the Internal Revenue Code or (2) promoting or marketing any tax-related matter addressed herein.

The handout is designed to provide accurate information regarding the subject matter covered. However, before completing any significant transactions based on the information contained herein, please contact us for advice on how the information applies in your specific situation.

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