**SOCIAL JUSTICE 102 CREATING NON-PROFITS**

**FROM THE DESK OF THE DEAN**

**TYPES OF CORPORATIONS**

**TOPIC 3**

**You will have a choice from a Liability, Tax and Raising Capital perspective of what type of company you want to start. Should you go with a S Corp or C Corp?**

**Which Is Best for You?**

Generally, S corp. status is preferred by small businesses, which usually fit within the legal limitations for an S corp. Certain types of corporations find more advantages with a C corp.

An S corp. is often not available to large corporations, those with a lot of start-up capital and large ambition, or those planning to sell stock globally. Large corporations may want the flexibility of being able to have more than 100 shareholders, sell shares to investors who are not U.S. citizens or resident aliens, have shares owned by other entities (corporations, LLCs, partnerships, trusts, etc.), or issue more than one class of stock.

Generally, an S corp is more popular with smaller businesses because of the likely tax savings, and a C corp is more popular with larger companies because of the greater flexibility to raise capital. However, whether a C corp. or S corp. would be best for your business is dependent upon careful analysis of various factors as they relate to your particular situation.

**S Corporation vs. C Corporation: The Similarities**

The C corporation is the standard (or default) corporation under IRS rules. The S corporation is a corporation that has elected a special tax status with the IRS and therefore has some tax advantages.

Both business structures get their names from the parts of the Internal Revenue Code that they are taxed under. C corporations are taxed under Subchapter C while S corporations are taxed under Subchapter S. To elect S corporation status when forming a corporation, Form 2553 must be filed with the IRS and all S corporation guidelines met.

Here are some of the qualities shared by both C corporations and S corporations:

· **Limited liability protection:** Corporations offer limited liability protection, so shareholders (owners) are typically not personally responsible for business debts and liabilities. This is true whether it is taxed as a C corporation or an S corporation.

·

**Separate legal entities:** Corporations (C corps and S corps) are separate legal entities created by a state filing.

· **Filing documents:** Formation documents must be filed with the state. These documents, typically called the [Articles of Incorporation](https://www.bizfilings.com/toolkit/research-topics/incorporating-your-business/what-are-articles-of-incorporation) or Certificate of Incorporation, are the same regardless of whether you choose to be taxed as an S corporation or C corporation.

·

**Structure:** S corps and C corps have shareholders, directors and officers. Shareholders are the owners of the corporation, but it is the corporation that owns the business. The shareholders elect the board of directors. The board oversees and directs corporation affairs and decision-making but is not responsible for day-to-day operations. The board elects the officers to manage daily business affairs.

·

**Corporate formalities:** The state corporation laws make no distinction between C corporations and S corporations when it comes to compliance responsibilities. All corporations are required to follow the internal and external corporate formalities and obligations, such as adopting bylaws, issuing stock, holding shareholder and director meetings, maintaining a [registered agent](https://www.bizfilings.com/starting-your-business/more-services/registered-agent) and registered office, filing annual reports, and paying annual fees.

**S Corporation vs. C Corporation: The Differences**

**Taxation**

For small business owners evaluating S corporations vs. C corporations, the decision usually comes down to how they want the corporation to be treated for federal income tax purposes.

* **C corporations:** C corps are separately taxable entities. They file a corporate tax return (Form 1120) and pay taxes at the corporate level. They also face the possibility of double taxation if corporate income is distributed to business owners as dividends, which are considered personal taxable income. Corporate income tax is paid first at the corporate level and again at the individual level on dividends.
* **S corporations:** S corps are pass-through taxation entities. They file an informational federal return (Form 1120S), but no income tax is paid at the corporate level. The profits/losses of the business are instead “passed-through” to the business and reported on the owners’ personal tax returns. Any tax due is paid at the individual level by the owners.
* **Personal income taxes:** With both C corporations and S corporations, personal income tax is due both on any salary drawn from the corporation and from any dividends received from the corporation.

**Corporate ownership**

As we mentioned, state corporation laws make no distinction between S corporations and C corporations. But the Internal Revenue Code does place several restrictions on who can be shareholders in order for the corporation to qualify to be an S corp.

* **Shareholder restrictions:** S corps are restricted to no more than 100 shareholders, and shareholders must be US citizens/residents. C corporations have no restrictions on ownership.
* **Ownership:** S corporations cannot be owned by C corporations, other S corporations (with some exceptions), LLCs, partnerships or many trusts.
* **Stock:** S corporations can have only one class of stock (disregarding voting rights), while C corporations can have multiple classes.

**S Corporation Advantages**

* **Single layer of taxation:**

The main advantage of the S corp over the C corp is that an S corp does not pay a corporate-level income tax. So any distribution of income to the shareholders is only taxed at the individual level.

* **20% qualified business income deduction**

The Tax Cuts and Jobs Act of 2017 gave eligible S corp shareholders a deduction of up to 20% of net “qualified business income”.

* **Pass-through of losses**

The losses of an S corp pass-through to its shareholders, who can use the losses to offset income (subject to restrictions of the tax law).

**S Corporation Disadvantages**

* **Limited number of shareholders**

An S corp cannot have more than 100 shareholders, meaning it can’t go public and limiting its ability to raise capital from new investors.

* **Other shareholder restrictions**

Shareholders must be individuals (with a few exceptions) and U.S. citizens or residents. This also makes it harder for an S corp to obtain equity financing, particularly because venture capital and private equity funds tend to be ineligible shareholders.

* **Preferred stock not allowed**

To be eligible for S corp status the corporation cannot have different classes of stock. Some investors want preferences to distributions or other privileges. An S corp cannot provide that.

* **Transfer restrictions**

Most S corps will restrict their shareholders’ ability to sell or transfer their shares. That’s to make sure they don’t end up with an ineligible shareholder which will cause the IRS to terminate its S corp status. This makes it harder for the shareholders of an S corp to exit the corporation.

**C Corporation Advantages**

* **Unlimited number of shareholders**

There is no limit on the number of shareholders a corporation taxed under Sub Chapter C can have.

* **No restrictions on ownership**

Anyone can own shares, including business entities and non-U.S. citizens.

* **No restrictions on classes**

A C corp can issue more than one class of stock, including stock with preferences to dividends and distributions.

* **Lower maximum tax rate**

The 2017 tax reform act lowered the corporate tax rate to a flat 21% and eliminated the alternative minimum tax. Even with the personal income tax rates being slightly lowered, this rate is lower than the maximum personal tax rate (which is currently 37%).

* **More options for raising capital**

Because Sub Chapter C of the tax code does not impose the same restrictions on ownership as Sub Chapter S, it is easier for a C corp to obtain equity financing.

**C Corporation Disadvantages**

* **Double taxation**

The main disadvantage of the C corporation is that it pays tax on its earnings and the shareholders pay tax on dividends, meaning the corporation’s earnings are taxed twice.

**When Would the Pros of an S Corporation Outweigh the Cons?**

There is no one size fits all answer to when a small business owner should choose an S corporation over a C corporation. It depends upon each individual situation. But the pros may outweigh cons when one or more of the following applies:

* You don’t plan on an IPO and are not looking to sell shares to more than 100 people or any other investors that are not permitted by Sub Chapter S.
* The corporation will be making distributions of income to shareholders.
* You don’t plan on issuing preferred stock.
* The shareholders’ tax liability—taking into account their personal income tax rate, deductions, and exemptions—will be lower using a pass-through entity than a separately taxed entity.
* You will have losses that you will be able to deduct from your personal income taxes to offset income, resulting in a tax saving.

**When Would the Pros of a C Corporation Outweigh the Cons?**

Again, there is no one right answer to that question, but here are some situations where a C corp may be a good option:

* Taxation under Sub Chapter C will result in lower taxes than taxation under Sub Chapter S.
* Distributions will not be made to shareholders.
* You plan on an IPO or seeking investors not allowed for an S corporation.
* You want shares to be freely transferable.
* You want to issue preferred stock.

**TOPIC 3**

**DISCUSSION QUESTION 1**

What are the strengths of an S corporation for you?

**DISCUSSION QUESTION 2**

What are the advantages of creating a C corporation for your company?

**DISCUSSION QUESTION 3**

Do you think you need an S or C corporation at this point in your career or pursuits Why?

**DISCUSSION QUESTION 4 with the Dean**

**PLEASE SET UP A PHONE CALL OR ZOOM CALL WITH THE DEAN FOR 15-30 MINUTES.**