Navigating
Income Tax

ENTITY SELECTION

Powerful Ideas: How Are C Corporations Taxed?

How Are C Corporations Taxed?

Corporations – in general

Entities created under state or federal statute that are referred to as incorporated, corporation, insurance company, or banking company are automatically classified as a corporation for tax purposes.[1] Unless the corporation elects special tax treatment, such as S corporation or real estate investment trust (REIT) treatment, the corporation will be taxed under Subchapter C of the Internal Revenue Code as a so-called C corporation.

Who can own a C corporation?

The stock of C corporations can be owned by individuals or other entities, including S corporations, LLCs, trusts, and partnerships. There is no limit to the number of shareholders who can own an interest in a C corporation. In addition, C corporations may have classes of stock with differing distribution rights, e.g., common stock with standard distribution rights and preferred stock which may allow the shareholder to receive his distributions before any are made to the common shareholders.

How is C corporation income taxed?

A C corporation reports its taxable income and tax liability on Form 1120 annually. The C corporation calculates its income, deductions and credits, and pays taxes on its taxable income, if its income is greater than its deductions and credits, at a flat rate of 21%. If a C corporation reports a loss, i.e., its deductions are greater than its income, a net operating loss (NOL) is created. As a result of the Tax Cuts and Jobs Act (TCJA), for tax years beginning after December 31, 2017, the deduction for net operating losses (NOLs) is limited to 80% of a corporation's income, and unused NOLs are able to be carried forward indefinitely to each tax year following the year of the loss. In 2020, to provide economic relief to businesses affected by the coronavirus pandemic, Congress enacted the CARES Act, providing a five-year carryback period and temporarily repealing the 80% limitation for NOLs arising in 2018, 2019, and 2020. Therefore, NOLs arising in tax years beginning after 2017 and before 2021 are allowed to be carried back to each of the five tax years preceding the tax year of such loss.

How are C corporation distributions taxed?

A distribution occurs when cash or assets are transferred to the shareholders of a C corporation. A distribution is generally taxable to the recipient, resulting in the infamous double taxation (because the C corporation has paid taxes on its income and shareholders are paying a second level of tax on the receipt of the distributions). The taxation of the distribution depends on who the recipient is and whether or not the C corporation has earnings and profits.[2]

If the distribution is made to a shareholder that is not another C corporation (e.g., an individual, S corporation, etc.), the distribution will be treated first as a dividend to the extent of earnings and profits and taxed at applicable dividend rates. Distributions in excess of earnings and profits will be treated as a return of capital and will reduce the shareholder's basis in his/her stock. These distributions will not be taxable to the shareholder. Any distributions in excess of earnings and profits and in excess of the shareholder's basis will taxed at capital gains rates.

If a distribution is made by a C corporation to a C corporation parent company (parent), the parent receives a deduction, called a dividends-received deduction, to avoid potential triple taxation of corporate income. The amount of the deduction can be 70%, 80%, or 100% depending on how much of the C corporation the parent owns.

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1 Note that LLCs and some other non-corporate entities may also elect to be taxed as C corporations.

2 Earnings and profits measures a C corporation's ability to pay dividends to its shareholders and should include all items of income, gain, loss, or deduction resulting from the economic activities of the C corporation.

What are the benefits of using a C corporation?

- C corporations can have an unlimited number of shareholders, from anywhere in the world.
- C corporations can have different classes of stock, creating flexibility and allowing them to attract investment capital.
- C corporations can offer deductible benefits to all shareholders.

What are the disadvantages of using a C corporation?

- Income reported by the C corporation may be subject to double taxation.
- C corporation income is generally taxed as ordinary income.
- A separate tax return is required to be filed, resulting in additional tax compliance.

Who should use a C corporation?

An entity taxed as a C corporation might be appropriate if:

- Shareholders may need to raise money from outside sources such as venture capital or private equity firms.
- Shareholders wish to have flexible profit sharing.
- Shareholders want flexibility to spread the business earnings between the corporation and shareholders for tax-reduction purposes.
- Shareholders wish to have flexibility to provide (through the corporation) substantial health, medical benefits, and other fringe benefits.

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