Understanding Dividend Distributions for S & C Corporations

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C corporations and S corporations are two types of business structures with key differences in how their income is taxed and the ownership restrictions they face.

Let's start by talking about C corporations. C corporations are separately taxed entities. They pay taxes at the corporate level at a flat rate of 21%. Also, when a C corporation makes a dividend distribution to a shareholder, that distribution is taxed as dividend income on the individual shareholder's tax return. C corporation income, therefore, faces double taxation – once at the corporate level and again when distributed to the corporate shareholders as a dividend.

The decision to pay dividends is typically made by the board of directors of a C corporation, based on the company's financial performance and future growth prospects. Dividends are usually paid out of the corporation's retained earnings, which are profits that the company has kept instead of being distributed to shareholders.

There is no limit on the number of shareholders that a C corporation can have. There are also no restrictions on ownership in a C corporation, and a C corporation can issue more than one class of stock, including stock with preferences to dividend distributions.

Now let's talk about S corporations. An S corporation is considered a pass-through entity, meaning that the company's income is passed through to its shareholders and taxed at the individual shareholder's level. Any income distribution to a shareholder is, therefore, only taxed once at the shareholder's individual tax rate.

A shareholder's individual tax rate can vary depending on that shareholder's tax situation in a particular year. Current tax rates range from 10 to 37%, however, S corporation shareholders may be able to take advantage of the Qualified Business Income (QBI) deduction to help reduce the taxes they pay on their share of the S corporation's income. Qualifying S corporation shareholders can claim a QBI deduction on their individual tax returns equal to 20% of their share of the net "qualified business income" from the S corporation.

An S corporation faces more restrictions when it comes to ownership than a C corporation. For example, S corporations cannot have more than 100 shareholders, and the shareholders must be U.S. citizens or residents. Partnerships and other corporations are not allowed as shareholders in an S corporation.

To be eligible for S corporation status, the corporation cannot have more than one class of stock. This means that distributions from an S corporation must be made pro rata based on each shareholder's ownership.

There are many factors to consider when deciding how to operate your business. The tax implications should be reviewed with your accountant as you determine if your business should be an S or C corporation.
Audits are a great way for companies to not only maintain compliance and regulation but also to monitor the different aspects of your company. Contact SVA for assistance with the audit needs.

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