The National Agricultural Law Center

Business Organizations Reading Room

C Corporations

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Introduction

The corporate business structure remains as one of the oldest options for organizing businesses, initially established in order to provide protection from the liability associated with owning and operating a business. Traditional corporations are now known as “C” corporations, also known as “C-Corps”, and while at one time many businesses were organized in this way, it is now only the largest businesses which choose this form of organization. C-Corps vary from other business structures in that the formalities to form and operate the business must be followed closely in order for the stockholders to maintain the protection provided by the corporate structure. The formalities associated with forming and operating a corporation are often tedious, but the protection from personal liability that the structure ultimate provides is practically unsurpassed by any other form of business structure.

Formation

The C corporation is one of the more complex business entities to form. C-Corps must have a board of directors, officers, corporate bylaws, and stock certificates for the initial owners of the corporation and other requirements depending upon the state in which it is created. They must file formal paperwork, or “articles of incorporation,” in the state where they choose to incorporate. Because of these formalities, this business structure cannot be formed without purposeful action, in contrast to a sole proprietorship or a general partnership. The agency in charge of registering and creating new businesses varies from state to state, but a list of these agencies and their contact information may be found at The National Agricultural Law Center under Forms and Filing Information: Business Organizations.

Liability

One of the most important features of the corporate structure is the almost unparalleled protection of the stockholders from personal liability as a result of actions of the business. Typically the protection provided by a corporation is called a “veil” or “curtain,” and it works to separate the actions and debts of the corporation from the stockholders and officers. Once established, C-Corps must follow “corporate formalities.” These are essentially requirements that a corporation must follow in order to maintain their protection against liability, including periodic meetings of the board of directors and mandatory record retention,.

As long as the corporation is operated as a legitimate business entity (i.e. it is not being used solely as a tax shelter or shield against creditors) than the actions of the corporation and its officers do not subject the stockholders to personal liability other than the value of the stock that the shareholder owns. Typically if a corporation fails the shareholders' stock certificates are devalued substantially (and often totally), but other than the loss in value of the stock certificates the creditors of the corporation do not have a private recourse against the individual stockholders.

One reason for this liability protection is the limited control that the shareholders exercise over the business entity. Shareholder have voting rights based on stock ownership (these voting rights are heavily influenced by the articles of incorporation), but these voting rights extend only to the right to elect officers and make substantial decisions such as mergers, buyouts, dissolutions, and similar activities. The majority of business decisions, however, are made by the corporate officers on a day to day basis with little to no input by stockholders.

<u>Example</u>: An investor bought $100,000 of stock from a C-Corp that soon went bankrupt. In this scenario, the stockholder may lose the $100,000 that he invested into the corporation, but the creditors of the corporation may not hold the stockholder responsible for anything beyond their investment. However, the investor may be held additionally liable if there was some form of fraudulent arrangement, allowing a court to "pierce the corporate veil" of the business entity.

Tax Structure

The liability protection of a corporation is a strong selling point for the corporate business structure. However, in this case the liability protection comes with a disadvantageous tax situation known as "double taxation." C Corporations are themselves treated as legal "persons." This means that the corporation must pay taxes on the money earned just as any ordinary citizen would pay them. Contrast this with the sole proprietorship and partnership structures, because those entities are disregarded for tax purposes and the tax is only assessed on the final recipient of the profits, the individual owners of the business.

However, the owners, or shareholders, of C Corporations also have to pay individual taxes on the profits that they receive, and this is where the term "double taxation" comes into use. When the profits of the corporation are distributed to the shareholders in the form of "dividends," the dividends are taxed as income to the shareholders of the corporation. As a result, the income generated by the corporation is taxed first at the corporate level and again at an individual level after it is distributed to shareholders in the form of a dividend.

The extra tax burden has made the C-Corp a less attractive option as states have created new business structures that provide essentially the same liability protection while allowing income to be taxed only on the individual level. The tax structure of corporations remains one of the largest concerns for individuals who wish to use the corporate business structure, however many businesses have chose to bear the burden associated with “double taxation” in order to benefit from organizing under one of the oldest, and most stable forms of business structure.

Termination

Unlike other business entities (such as partnerships and sole proprietorships) that exist only until the owner(s) quit or die, the corporation survives. Many larger corporations have been in existence for decades, yet the transferability of the stock certificates (unless specifically limited by the articles of incorporation) allows a corporation to continue indefinitely. There are typically two ways for a corporation to terminate. The first and by far the most likely means of termination is accomplished by a vote of the shareholders. Either the state corporation statutes or the corporation’s articles of incorporation will set forth the amount of votes needed to terminate the corporation’s existence. The other way that corporations may be terminated is by a court order. If shareholders can show that the board of directors or the shareholders are unable to meet the dissolution requirement and that the shareholder interests are being devalued because of the inability to terminate the corporation (or because of waste or fraud) than a court has the authority to issue a judicial dissolution.

Conclusion

The reason for the continued popularity of the corporate business structure is that for truly large businesses this structure provides a workable model for business operations. The liability protections provided by the traditional corporate structure are among the most solid protections currently available through business organizations and the age of the corporate business structure means that there are a large number of cases and statutes clarifying the nuances of the corporate entity. On the other hand, the corporate formalities that the shareholders and officers of the corporation must observe can be burdensome, especially in smaller corporations where the formalities are not needed to maintain an orderly business environment. The other serious drawback to the corporate business structure is “double taxation.” Since income is taxed on both the corporate the personal level, it is inefficient to distribute profits back to shareholders. While it is possible to bypass the issue if the corporation reinvests profits instead of distributing dividends, this option is not popular because many investors anticipate a steady stream of income from dividends. However, even with these drawbacks the C Corporation remains as a popular business structure.