

# THEME: C CORPORATIONS

By John W. Day

## **ACCOUNTING TERM: Corporation**

A corporation is a person or persons granted a charter from a state that legally recognizes it as a separate entity having its own rights, privileges, and liabilities distinct from its individual owners.

## **FEATURE ARTICLE: The Organizational Structure of a Corporation**

### **Initial set-up**

There are many types of corporations. There are private corporations, public corporations, non-profit or non-stock corporations (such as churches, universities, and hospitals) and governmental corporations (such as cities and townships, etc.) The rules and regulations governing these entities can be highly complex. For this article, my focus will be on the small private corporations commonly known as “close” corporations.

To form a corporation, as mentioned above, one or more incorporators submit an application to the appropriate authority of a state government. The application identifies who the incorporators are, the nature of their business, and describes the capital stock to be authorized and issued. Once approved and the state fee is paid, “articles of incorporation” are issued by the state as legal evidence of the corporation.

A package containing the articles of incorporation, shares of stock, a stock register, the corporate seal and a state corporation identification number is usually received within a few days. Stock certificates indicating a purchase of a number of shares can then be issued. The number of stock shares issued cannot exceed the number of stock shares authorized.

This package containing important corporate documents should be stored in a safe place. I have clients who incorporated twenty-five years ago and would be hard pressed to find that package today. It may be a problem if and when they decide to sell their shares of stock or issue new shares to a new investor or a relative.

The first item of business is to hold a meeting to elect a board of directors. Often, if there is only one or two stockholders, they elect themselves as president and vice president and double duty as secretary and treasurer. This meeting is usually held in the office of the attorney who helped incorporate them. The average fee for an attorney to set up an corporation is \$1,000 to \$2,000. However, there are organizations, such as The Company Corporation, that will

set up a corporation for between \$150 and \$500.

Once incorporated, the Internal Revenue Service (IRS) expects the organization to conduct itself as a corporation. This means holding at least one board of directors meeting per year where resolutions are passed regarding important business decisions, such as, setting salaries of the working officers, setting aside funds for large purchases, whether the company will operate under the “full accrual” accounting system or an alternative system such as “cash”, or “modified cash”, and etc.

It is tempting for small “closely held” corporations to forgo these formalities, but the risk is that the IRS could deny the organization corporate status which would force the company to file a tax return as a sole proprietor or partnership when the books were set up as a corporation. In other words, it could be messy.

During the first board meeting a set of “bylaws” are established and adopted. These bylaws are the rules which the company follows so that all parties operate on the same page.

### **Ownership equity**

When the initial stock of a corporation is sold at a pre-established price, that price becomes the “par value” or “stated value” of the stock. For instance, let’s say that you incorporated your business and the state authorized the selling of 1,000,000 shares of stock. You and your business partner decide that each share is worth \$1.00. You purchased \$50,000 worth of shares or 50,000 shares and so did the other stockholder. This means 100,000 shares of stock were issued and are outstanding at a stated value of \$1.00 per share. Each shareholder owns 50% of the outstanding shares (100,000/50,000). There are 900,000 shares of stock remaining available to be issued.

Establishing a stated value or par value of stock is considered a corporation’s “legal capital”. This may provide some protection for the shareholders because it is generally illegal for a corporation to pay dividends or repurchase shares if doing so impairs the legal capital. Keep in mind, though, that in these small, closely-held corporations where there are only a few stockholders who are running the organization, this is not likely to happen. This means par value and stated value may have no real relevance.

Since there are only two stockholders in our example and it is agreed that neither is entitled to any special privileges (preferred stock) there will be only one type of capital stock to be issued. This class of stock is called “common stock” and has basic rights associated with it. The primary characteristics of common stock are the:

- (1) Right to vote for directors and thus to be represented by management.

- (2) Right to receive dividends declared by the board of directors.
- (3) Preemptive right to purchase additional shares of capital stock in proportion to present holdings in the event that the corporation increases the amount of stock outstanding.
- (4) Right to share in the distribution of cash or other assets if the corporation is liquidated.

The journal entry, when the initial purchase occurs, would look like this:

DESCRIPTION	DEBIT	CREDIT
Cash	100,000	
Common Stock		100,000
100,000 Shares of no-par common stock, stated value \$1 a share		

When there is only one class of stock, the terms “common stock” and “capital stock” can be used interchangeably in the general ledger.

Sometimes more capital is required of the stockholders. No additional shares are issued so the cash or property contributed is identified separately in the equity section of the balance sheet as “paid-in-capital”. Each shareholder is responsible for keeping track of his/her own stock basis for tax reasons in the event the stock is sold. Basis means the amount paid for stock shares.

The journal entry for “paid-in-capital” would be written as follows:

DESCRIPTION	DEBIT	CREDIT
Cash	10,000	
Paid-in-Capital		10,000
Excess over stated value of common stock		

I should mention the concept of “treasury stock” since that question comes up from time to time. Treasury stock is stock reacquired by a corporation to be retired or resold. Treasury stock is issued but not outstanding, and is not taken into consideration when calculating earnings per share or dividends, or for voting purposes. In fact, California doesn’t recognize treasury stock, so if the company buys back some outstanding stock it just decreases the common stock at its issuance price. Furthermore, it increases or decreases paid-in-capital depending on whether the buy back was higher or lower than the issuance price. But the laws vary in different states. This is something you will have to research in the state which you live.

## Retained Earnings

Retained earnings are accumulated earnings that haven't been distributed to shareholders in the form of dividends. In other words, the net income or loss from the business is closed out each year into the retained earnings account. If dividends are paid, they come out of retained earnings. The activity in retained earnings reflects the earnings (or losses) minus dividends since the inception of the business.

Think about it like this: If the company had a net profit of \$100,000 in its first year and paid no dividends, the retained earnings account would be \$100,000. In the next year, if the company bought assets for \$25,000 and paid off debt of \$50,000 with the cash earned in the first year and then had a net profit in the second year of \$40,000 and paid no dividends, the retained earnings account would show \$140,000. In other words, the company retained its earnings and used \$75,000 for reinvestment in assets and the payment of debt. Retained earnings is not a measure of the company's assets.

I used to work as an internal auditor for a newspaper chain that had ten different newspapers up and down the west coast. It was a very profitable business. The company's retained earnings were substantial since the company had been in business over fifty years. I remember that someone attempted to sue the company for liable in one of its newspapers. The treasurer of company, my boss, had to go to court to explain the financial status of the company. He told me that the plaintiff tried to argue that he was entitled to a huge settlement because the company's retained earnings were so large. My boss was somewhat amused as he had to teach this fellow some basic principles of accounting.

As you may know, an increase to retained earnings requires a credit entry and a decrease requires a debit entry. Items that cause a debit entry would be: net loss; dividend declared; and prior period adjustment to correct a material error from a previous year. Items that cause a credit entry would be net income and prior period adjustment. There can be a negative retained earnings balance. In this case, it is called "retained deficit".

At the end of the year, if you have a corporation, most computerized accounting software programs automatically close the net income or loss directly into the retained earnings account. There is no journal entry required. If a dividend is paid you would see a journal entry such as this:

DESCRIPTION	DEBIT	CREDIT
Retained Earnings	1,000	
Cash		1,000
To record dividends paid for the year.		

If you would like a more detailed explanation of the stockholder equity accounts, go to <http://www.accountingcoach.com>. Choose the “Stockholders’ Equity” topic.

You may often see in your computerized accounting software the account name Retained Earnings no matter what business entity you are using. This causes some confusion for people who have a sole proprietorship or partnership. But you can now see that “retained earnings” really only works for a corporation. If you can’t change the name in your software, then all you can do is make sure you understand the nature of your accumulated equity account and how it functions.

The accounting procedures for a corporation are basically standard except for the accounts found in the equity section. If you decide to incorporate, plan on more formality and expense. You are required to keep an adequate set of books that includes a balance sheet and income & expense statement. A federal form 1120 corporate tax return will have to be prepared. These are considerations to be weighed against the benefits of incorporating.

**QUESTION: What Are The Advantages and/or Disadvantages of Incorporating?**

No sense rewriting these, so I just lifted this schedule out of my online Accounting for Non-Accountants course:

**CORPORATIONS**

Characteristic	Advantages	Disadvantages
Organization	<ul style="list-style-type: none"> <li>- Ability to raise money through sale of stock</li> <li>- Carries own legal status separate from owners</li> </ul>	<ul style="list-style-type: none"> <li>- Corporate charter restricts types of business activities</li> <li>- Expensive to set up</li> </ul>
Accounting		<ul style="list-style-type: none"> <li>- Formal accounting and bookkeeping required</li> </ul>
Personal Liability	<ul style="list-style-type: none"> <li>- Shareholders are not liable for debts incurred by corporation</li> </ul>	<ul style="list-style-type: none"> <li>- If the corporation is undercapitalized, officers or shareholders may have to sign personally to get credit</li> </ul>
Taxation	<ul style="list-style-type: none"> <li>- Depending on income, tax rate may be less than</li> </ul>	<ul style="list-style-type: none"> <li>- Corporate tax return must be filed (Form</li> </ul>

	personal	1120) - Double taxation if dividends are issued
Ownership Control	- Stock majority controls	- If 50/50 stock ownership must make joint decisions
Ownership Compensation	- Working stockholder must be employee - Company pays half of payroll taxes	- Compensation limited to "reasonable amount"
Transfer of Ownership	- Easy to transfer ownership through sale of stock	

**TIP: Some Words to the Wise**

(1) Be careful about what assets you put into the corporation. "Easy to put in, hard to get out" is an old saying. You may be the sole stockholder, but, the only way you can get money out is through **salary, dividends, lease-backs, loans or a sale of your stock**. If you own a building and contribute it to the corporation the corporation now owns it. If the building sells, the corporation pays tax on the profit. But how can you get your hands on the money? Perhaps it may make more sense to lease the building to the corporation so that you retain ownership.

(2) Keep your eye on the "accumulated earnings tax". What is it? Here is a direct quote from the Law Library:

A special tax imposed on corporations that accumulate (rather than distribute via dividends) their earnings beyond the reasonable needs of the business. The accumulated earnings tax is imposed on accumulated taxable income in addition to the corporate income tax.

Investopedia says :

The federal government produced this tax to deter investors from negatively influencing a company's decision to pay dividends. Essentially, this tax persuades companies to issue dividends, rather than retaining the earnings.

The premise behind this tax is that companies that retain earnings typically experience higher stock price appreciation. Although this is beneficial to stockholders, as capital gains taxes are lower than dividend taxes, it is detrimental to the government because tax revenues decrease. By adding an extra tax upon a firm's retained earnings, the taxman will either collect more taxes from the company or persuade them to issue dividends, thereby allowing the government to collect from the stockholders.

## At what point will the IRS impose this tax? Here's what the Business Owners Toolkit had to say:

You may have heard that a corporation can accumulate its earnings: Once it pays tax on them at the corporate level, it need not pay them out as dividends and can thus avoid the second part of the double taxation scheme. This is true with some caveats.

From 2003 through 2008, the IRS imposes an additional "accumulated earnings" tax of 15 percent (previously set at the highest individual tax rate before enactment of the Jobs and Growth Tax Relief Act of 2003) on earnings a corporation accumulates above \$250,000. The limit is \$150,000 for certain "personal service corporations" (i.e., corporations in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, where the owners provide the services). This tax does not apply to LLCs.

This tax is designed to dissuade corporations from accumulating earnings just to avoid paying taxable dividends. However, this tax is usually easy to avoid, for three reasons:

- Earnings can be reduced to zero, through the withdrawal of earnings in deductible ways such as higher salaries for the owners
- The corporation can accumulate earnings beyond these limits, provided it can prove it has a business need to do so, such as payment of anticipated future operating expenses, a planned business expansion, etc.
- The corporation can elect to be treated as a conduit for tax purposes, by making a subchapter S election which eliminates this problem.

(3) For year-end tax planning purposes it may not be too difficult to reduce the profit in the corporation to zero by awarding bonuses to stockholder officers who work in the business. Usually they are underpaid in the first place. However, be sure to stay within the IRS guidelines of a reasonable salary and double check to make sure whether the tax rates on the corporate level are lower or higher than that of the personal level. Also, be sure to adopt a resolution for bonuses at the board of directors meeting.

(4) When an officer borrows money from the corporation a formal note with interest and a repayment schedule should be established. If this is not done, the IRS can determine that it was not a note but was really a dividend and assess taxes and penalties. The rule of thumb is that, if the loan is \$10,000 or less, the IRS doesn't pay much attention to it.

(5) If an officer likes to take a draw or only does so when there is some money available, use the Officer Advance account to manage the irregularities. Remember, officers must take a formal payroll salary. Establish a salary amount that is fitting and do not issue a check to the officer on pay day. Rather, show the net check amount as a credit to the Officer Advance account. This will offset the debits to Officer Advance the officer took during the month in the form of draws. Keep a close watch on the balance in the Officer Advance account and toward the end of the year either increase or decrease the officer's salary to make up the difference.

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