

# Avoiding Double Taxation On Corporate Earnings



## What is Double Taxation?

If you're wondering what double taxation is, it's exactly what it appears to be: being taxed twice on the same income.

C corporations usually bear the brunt of double taxation, since their business structure dictates that a corporation is a separate tax-paying entity.

Other common business structures such as an LLC, Sole Proprietorship, or S corporation are not taxed on business income separately, but instead pass any tax liability on to the owners or members, where it's reported on their personal tax return.

So how does double taxation work? Because they are recognized as a separate legal entity, C corporations are required by law to pay business taxes on any earnings.

If that same C corporation later pays dividends to shareholders, those earnings are taxed twice.

This also applies to owners who take a salary from the corporation, as they'll be required to pay taxes on both corporate income as well as on their own earnings.

However, there are some benefits to taking a salary, which we'll explore later.

Double taxation can also become an issue for companies that operate in more than one country.

For example, if your business is headquartered in Texas, but you also maintain operations in Italy, chances are that you'll need to pay tax authorities in Italy, as well as those in the U.S.

Most countries have tax agreements in place that reduce the occurrence of double taxation between locations.

If you're not sure exactly how double taxation can impact a company, we'll use a fictitious company to explain the entire process.

In 2019, Jeff and Marge Johnson opened Johnson Aviation, a business that builds wiring harnesses for airplanes.

Though there was some discussion about what type of business structure to use, the Johnsons decided to incorporate Johnson Aviation.

With a first-year income of \$300,000, Johnson Aviation had a tax liability of \$63,000 based on the current corporate income tax rate of 21%.

Because they were still in the start-up phase, they kept their profit in retained earnings, paying no dividends to their five shareholders, eliminating the possibility of double taxation for 2019.

However, in the following year, Johnson Aviation's corporate earnings tripled, rising to \$900,000. With this jump in income, some of Johnson Aviation's investors began to clamor for a return on their investment.

Thus Jeff and Marge Johnson decided to place the majority of their 2020 income into retained earnings to use towards business growth while also paying dividends to their shareholders.

For 2020, Johnson Aviation paid a total of \$189,000 in corporate taxes, placing \$700,000 into retained earnings, while paying shareholder dividends with the

other \$200,000.

But because Johnson Aviation is a C corporation, their shareholders will also pay taxes on the dividends they receive, even though the corporation has already paid taxes on the earnings.

That is double taxation.

*Even if you do decide to structure as a C corporation, there are ways you may be able to avoid or reduce double taxation on the corporate level.*

## Can you avoid double taxation in your business?

The best way to avoid double taxation is to simply not structure your business as a C corporation.

If you do choose to incorporate as a C corporation, you may be able to reduce the amount of double taxation you pay, but it can be next to impossible to avoid double taxation entirely. This is particularly true if you regularly pay dividends to shareholders.

Because C corporations are considered separate legal entities, they do offer some advantages, including the ability to have an unlimited number of shareholders. C corporations also offer businesses the widest range of allowable deductions and expenses.

However, if you want to avoid double taxation, you may want to consider one of these legal structures.

- **Sole proprietorship:** A sole proprietorship has no distinction between the business and its owner. A sole proprietorship can be a good option for a sole owner that has no intention of growing his or her business. Many small businesses start as sole proprietors but later opt for a different business structure. However, if you have plans to expand from the beginning, skip this business entity altogether for one of the other business structures.
- **Partnership:** A partnership is an agreement between two or more

individuals. There are two types of partnerships; a general partnership, where partners share equal responsibility for the business, and a limited partnership, where some partners may only be investors and have no say in the business. A partnership is considered a pass-through entity, with each partner's net income passed through to each partner, who is responsible for paying tax on their personal income tax return.

- **S corporation:** S corporation shareholders are taxed like partners in a partnership, with earnings and losses passed through to each shareholder. An S corporation is a good substitute for those that wish to incorporate but want to avoid duplicate taxes.
- **Single-member LLC:** A single-member limited liability company or LLC is a pass-through entity. The sole member of the single-member LLC is taxed individually, with no tax liability for the LLC. Only if you elect to be taxed as a corporation itself will the LLC have a tax liability.
- **Multi-member LLC:** Similar to the single-member LLC, a multi-member LLC is a pass-through entity unless you request to be taxed as a C corporation. Like a partnership, both a single-member and a multi-member LLC requires each member to report all income on their personal tax return.

Even with all of the available options, after careful consideration, you may find that structuring as a C corporation is the best choice for your business.

However, even if you do decide to structure as a C corporation, there are ways you may be able to avoid or reduce double taxation on the corporate level.

1. Put more income into retained earnings

By putting more of your business income into retained earnings, you can cut down on double taxation.

This is a particularly good option for newer businesses still in a growth phase since it's important to use retained earnings to fund company growth.

However, as your business grows, it becomes more likely that you will need to begin paying dividends to your shareholders.

For more established businesses, this option may not be feasible, particularly if current shareholders are used to receiving dividends.

## 2. Employ family members

On a personal level, if most of your shareholders are family members, they can receive a salary working for the business. This eliminates the need to pay out dividends, and the salary expense becomes a deductible expense for your business.

Of course, your shareholders do not have to be family to become employees.

This way, any profit earned can be easily distributed to shareholders in the form of a salary or bonus, and while your employees will still have to pay the appropriate amount of income taxes on their personal tax return, you'll no longer be double taxed on dividend payments that you distribute.

## 3. Split income

Taking a salary may be one of the most efficient ways to cut down on double taxation.

Following the same process as employing family members or shareholders, income splitting allows business owners to draw a salary directly from any profit earned, leaving the balance of the profit in the corporation.

Though business owners will need to pay taxes on their individual tax returns, it will effectively reduce the amount of business taxable income as well as the amount you'll have to pay double taxes on.

## 5. Borrow from the business

Again, this option works best if you don't have a large group of investors that you normally pay dividends to.

However, if you're the only shareholder, consider taking a loan from the business.

Keep in mind, however, that the IRS tends to scrutinize this process closely, so if you do opt for borrowing from the business, be sure that you have documentation that includes the loan details, including a repayment plan with a reasonable interest rate.

## 6. Don't structure as a C corporation.

One of the best ways to avoid double taxation is to ask the IRS to treat your business as an S corporation for tax purposes, as S corporations are exempt from the double taxation that directly affects both corporations and their shareholders.

Because there are no corporate tax requirements for an S corporation, all company profits can flow directly to shareholders, eliminating double taxation.

Keep in mind that S corporations carry some restrictions, including the number and type of shareholders a company may have, as well as restrictions on stock classes as well.

## **Double taxation can't always be avoided**

While all of the above scenarios may be appropriate for some businesses, they may not work for your business.

If you've explored other structures and determine that a C corporation structure is the best fit for your business, the reality is that aside from not paying dividends to shareholders, there's not a lot that you can do to avoid double taxation.

If you're still not sure what structure would be best for your business, be sure to consult your CPA, tax advisor, or attorney to help you work through the options to see what structure is best for your business.

## **Tax planning is key for any business**

Though double taxation mainly impacts larger corporations that pay dividends regularly, even small business owners can be impacted by double taxation.

Business owners can avoid double taxation by reinvesting any earnings into the company, or declining to pay stockholder dividends.

Whatever structure you decide is best for your business, know that proper tax planning can be beneficial.

Whether your business is an LLC, Sole Proprietorship, or C corporation, properly planning for taxes can help you reduce expenses while boosting profits for your business.

# What's your goal today?

## 1. Use PLANERGY to manage purchasing and accounts payable

We've helped save billions of dollars for our clients through better spend management, process automation in purchasing and finance, and reducing financial risks. To discover how we can help grow your business:

- Read our case studies, client success stories, and testimonials.
- Visit our "Solutions" page to see the areas of your business we can help improve to see if we're a good fit for each other.
- Learn about us, and our long history of helping companies just like yours.

[Book a Live Demo](#)

## 2. Download our guide "Preparing Your AP Department For The Future"

Download a free copy of our guide to future proofing your accounts payable department. You'll also be subscribed to our email newsletter and notified about new articles or if have something interesting to share.

[download a free copy of our guide](#)

## 3. Learn best practices for purchasing, finance, and more

Browse hundreds of articles, containing an amazing number of useful tools, techniques, and best practices. Many readers tell us they would have paid consultants for the advice in these articles.

## Related Posts