

Starting a Business - Pros and Cons of S Corporations

Dear Client:

Since you have indicated that you may be interested in operating your new business as an S corporation, here is a checklist highlighting advantages and disadvantages of the S corporation form. Especially popular among small businesses, the number of S corporations has quadrupled in the past 15 years and, hands down, is the most common form of doing business except for the unincorporated sole proprietorship. While its popularity indicates that consideration of operating your business as an S corporation is certainly wise, "going with the crowd" is not always the best choice. What is right for your business and your unique circumstances should control.

Some of the advantages of operating a business as an S corporation are:

1. Your personal assets will not be at risk because of the activities or liabilities of the S corporation (unless, of course, you pledge assets or personally guarantee the corporation's debt).
2. Your S corporation generally will not have to pay corporate level income tax. Instead, the corporation's gains, losses, deductions, and credits are passed through to you and any other shareholders, and are claimed on your individual returns. The fact that losses can be claimed on the shareholders' individual returns (subject to what are known as the passive loss limits -- S corps pay tax at the highest corporate rate on their excess passive income) can be a big advantage over regular corporations. Liquidating distributions generally also are subject to only one level.
3. The S corporation has no corporate alternative minimum tax (AMT) liability (however, corporate items passed through to you may affect your individual AMT liability).
4. FICA tax is not owed on the regular business earnings of the corporation, only on salaries paid to employees. This is a potential advantage over sole proprietorships, partnerships, and limited liability companies.
5. The S corporation is not subject to the so-called accumulated earnings tax that applies to regular corporations that do not distribute their earnings and have no plan for their use by the corporation. Nor because of their pass-through nature do they risk being characterized as a personal holding company.

Some of the disadvantages are:

1. S corporations cannot have more than 100 shareholders (but with husband and wife being considered as only one shareholder). Further, no shareholder may be a nonresident alien.
2. Corporations, nonresident aliens, and most estates and trusts cannot be S corporation shareholders. Electing small business trusts, however, can be shareholders, a distinct estate planning advantage.
3. S corporations may not own subsidiaries, which can make expansion difficult, unless the subsidiary is a Qualified Subchapter S Subsidiary (a 100% owned S corporation or QSub); and termination of the QSub's status can be treated as a sale of assets.
4. S corporations can have only one class of stock (although differences in voting rights are permitted). This severely limits how income and losses of the corporation can be allocated among shareholders. It also can impair the corporation's ability to raise capital. However, the Small Business and Work Opportunity Tax Act of 2007 eliminated the treatment of bank director stock as a second class of stock.

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5. A shareholder's basis in the corporation does not include any of the corporation's debt, even if the shareholder has personally guaranteed it. This has the effect of limiting the amount of losses that can be passed through. It is a disadvantage compared to partnerships and limited liability companies, and is one of the main reasons that those forms are usually used for real estate ventures and other highly-leveraged enterprises.
6. S corporation shareholder-employees with more than a 2-percent ownership interest are not entitled to most tax-favored fringe benefits that are available to employees of regular corporations.
7. S corporations generally must operate on a calendar year.
8. An S corporation may be liable for a tax on its built-in gains, if, among other things, it was a C corporation prior to making its S corporation election. Under the American Recovery and Reinvestment Act of 2009, no tax will be imposed on an S corporation's net recognized built-in gain if the seventh tax year in the 10-year recognition period preceded the tax year for a tax year in 2009 or 2010. Under the Small Business Jobs Act of 2010, Congress shortened the holding period even further, to five years, in the case of any tax year beginning in 2011, if the fifth year in the recognition period precedes the tax year beginning in 2011.

Some of these factors will be more important than others, depending upon the particular circumstances. If you would like to pursue this matter further, and have us fully evaluate your situation, please do not hesitate to call.

Sincerely yours,

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