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S CORPORATIONS

(Choosing the Proper Entity for Your Business – Part 3)

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S Corporation is a corporation that has elected to be taxed under Subchapter S of the Internal Revenue Code. This type of entity enjoys both the limited liability of corporations and absence of double taxation of sole proprietorships and partnerships. The corporation elects to be pay zero corporate federal tax and to pay a super-low California franchise tax of only 1 ½ %. S corporations enjoy the best of both worlds of sole proprietorships and corporations. ☺

A. Advantages:
1. Single tax - The entity escapes taxation at the corporate level. There is only a one-time tax at the shareholder level. The net income is passed through a K-1 to the shareholder.
2. Corporate net losses - are also passed through and taken advantage by the shareholder to offset other income. For example, a shareholder's loss of $20,000 can offset the spouse' $30,000 wage leaving the couple with zero taxable income after deducting standard deduction and personal exemptions. Nice.
3. Limited liability - is enjoyed since it is a corporation, a separate entity.
4. Self-employment tax - does not apply to the net income of S corporations. This savings can be substantial, as the shareholder does not have to pay FICA of about 15% on the net income passed through from the corporation. This savings in the first year alone can pay for incorporating costs.
5. Accumulated earnings tax - does not apply to S corporations.
6. Personal holdings tax - does not apply to S corporations.
7. Alternative minimum tax - also does not apply to S corporations.
8. Trust Fund - Discuss with your tax adviser how you can save on the employer's portion of problematic delinquent payroll taxes.
9. Passive losses - of passive S corporation shareholders can be offset against passive loss activities with their S corporate earnings.
10. Deductible business interest - S corporate shareholders who incurred debt to acquire company stock may deduct the expense as business interest if they materially participate (debts of sole proprietors are treated as investment interest that can only be offset against investment income).

B. Disadvantages:
1. Some fringe benefits received by 2% shareholders are not excludable from shareholder income. These include $50,000 group term insurance, health insurance premiums, meals and lodging for the convenience of the employer, and the $5000 death benefit exclusion.
2. Calendar year - must be used generally.
3. Pension plan borrowings - prohibited for 5% shareholders.
4. New shareholders may miss to file S election documents or existing dissident shareholders may purposely cause trouble by making a disqualified transfer of stock..
5. Higher marginal tax - than a C corporation could result.
6. Limitation on the use of cash basis - an S corporation that has more than 35% of its losses allocated to shareholders who do not actively participate in the management of the company will be treated as a tax shelter and therefore will be required to use the accrual method of accounting.
7. Tax liabilities of an S corporation in trouble could end up with the shareholders (as opposed to being trapped inside a C corporation). You could enjoy the tax benefits of an S corp and switch to C corp as soon as problems are anticipated.