

S corporation as choice of entity

Dear Reader:

This letter is in furtherance of our discussion regarding the business you and your co-venturers plan to conduct. As we discussed, an S corporation is the most suitable form of business for the new venture. Here is an explanation of the reasons why.

In your situation, the biggest advantage of an S corporation over a partnership is that as S corporation shareholders you would not be personally liable for corporate debts. In order to receive this protection, it is important that the corporation be adequately financed, that various formalities required by our state be observed (e.g., filing articles of incorporation, adopting by-laws, electing a board of directors, and holding organizational meetings), and that the existence of the corporation as a separate entity be maintained.

Because you expect that the business will incur losses in its early years, an S corporation is preferable to a C corporation from a tax standpoint. Shareholders in a C corporation generally get no tax benefit from such losses. In contrast, as S corporation shareholders, each of you can deduct your percentage share of these losses on your personal tax return to the extent of your basis in the stock and in any loans you make to the entity. Losses that cannot be deducted because they exceed your basis are carried forward and can be deducted by you when there is sufficient basis.

Once the corporation begins to earn profits, the income will be taxed directly to you whether or not it is distributed. It will be reported on your individual tax return and be aggregated with income from other sources.

The business plan indicates that you plan to provide fringe benefits such as health and life insurance. You should be aware that the costs of providing such benefits to a 2% or more shareholder are deductible by the entity but are taxable to the recipient. This treatment will apply to you since each of you will own more than 2% of the entity.

As I mentioned, the S corporation could inadvertently lose its S status if either of you transfers stock to an ineligible shareholder such as another corporation, a partnership, or a nonresident alien. If the S election were terminated, the corporation would become a taxable entity. You would not be able to deduct any losses and earnings could be subject to double taxation—once at the corporate level and again when distributed to you. In order to protect you against this risk, I recommend that each of you sign an agreement promising not to make any transfers that would endanger the S election.

