CLIENT REPORT

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. As you take a look please keep in mind that Congress may pass S corporation reform that would eliminate or lessen some of the current disadvantages. Just call us for an update.

Some of the advantages are:

- 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).
- 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) can be a big advantage over regular corporations. Liquidating distributions generally also are subject to only one level of tax.
- The S corporation also has no corporate alternative minimum tax (AMT) liability (however, corporate items passed through to you may affect your individual AMT liability).
- 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.
- 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.

Some of the disadvantages are:

- S corporations cannot have more than 100 shareholders (but with husband and wife, or an entire family in some cases, being considered as only one shareholder). Further, no shareholder may be a nonresident alien.
- Corporations, Partnerships, nonresident aliens, and most trusts cannot be S corporation shareholders. Electing small business trusts, however, can be shareholders, a distinct estate planning advantage.
- 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).
- 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 to shareholders.
- 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.

- 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.
- S corporations generally must operate on a calendar year.

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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