

# Should you form an S-Corp?

As their businesses get more complicated, I often see entrepreneurs considering other forms for their enterprise, including S corporations, C corporations, limited liability companies, and partnerships. I've attended professional education sessions where lawyers and other experts have raved about the distinct and clear advantages of one form of entity or another, and I've concluded that, in fact, there is no magic bullet. The "right" entity depends on individual circumstances, and on understanding the advantages of each form of business. Having said that, we'll explore the pros and cons of setting up an S corporation.

- **Limited personal liability.** Corporate structures, including S corps, allow you as an owner to limit some of your personal liability. For example, creditors of an S corporation generally can go after only the assets of the corporation, not the owner's, if debts are unpaid. However, lawyers tell me that the legal protections of corporations are not ironclad. For example, owners of small S corps have to be careful to keep their own financial affairs and those of the corporation strictly separate if they want to maintain limited liability. The corporate structure also does not protect you against liability for your own actions. As always, what appears on this site shouldn't be taken as legal advice — your best bet is to consult privately with an attorney about legal questions.
- **Pass-through of losses.** One advantage an S corp holds over C corporations is that corporate losses can pass through to shareholders. So, if you've invested \$20,000 in a business that you're running and the venture loses \$10,000 in the first year, you can take that loss against other income on your personal income tax return. (Note: S corp shareholders cannot take current-year losses that exceed their adjusted basis in the company, plus the adjusted basis for corporate debt owed to the shareholder. If you don't understand how all this is determined, you've reached one of those points where you need to talk with your tax pro.)
- **No corporate taxes** — but that doesn't mean no corporate tax returns. S corporation profits and losses pass through to owners, so the S corp itself doesn't pay federal income taxes. However, the corporation still has to file a tax return (Form 1120S) showing profits and losses. As a shareholder, you then report the pass-through of income and loss on your personal tax return. The corporation also will probably have to pay some sort of minimum annual state franchise fee or tax, and may have to file a state corporate income tax return as well. "I think one of the main reasons people use S corporations is the self-employment tax and desire to minimize it," says Tony Mancuso, an attorney and author of "Form Your Own Limited Liability Company." Of course, the IRS is wise to the potential for abuse by people who hate paying self-employment taxes. If you work for or are the owner of an S corp, you have to be paid a reasonable salary for what you're doing. Page 2 of 2

Confidential Page 2 8/14/2020 Being the president of the company and taking a salary of \$15,000 and dividends of \$80,000 probably won't cut it in an audit. And the big downside to an S corp:

- **Tax treatment of benefits.** An S corporation can provide its employees with such benefits as accident and health insurance premiums. Simple, right? Hardly. If you are an employee who is also a 2% (or more) shareholder, the corporation gets to deduct these items, but the expenses are added back to your own gross income. As an added twist, the amounts aren't subject to Social Security and Medicare taxes, even though you pay regular income tax on them. There also are some restrictions on S corps. For example, there cannot be more than 75 shareholders in an S corporation. All shareholders have to agree to the election of S

**corp status. There cannot be more than one class of stock. And all gains and losses have to be passed through proportionate to the shareholder's stock stake in the company. No one said that running your own company was easy.**