



Robert W. Wood

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Key Facts About Corporations, S Elections & Buy-Sell Agreements

If you start a business and don't form an entity, the income and expense goes on Schedule C to your personal tax return. Schedule C, it turns out, is the single most likely type of tax return to be audited by the IRS. Ouch. That in itself can be a reason to form an entity. Other reasons include liability protection and allowing for multiple owners.

For many years, when an individual outgrew a proprietorship, a corporation was the norm. Today, limited liability companies (LLCs) are popular. But despite the inroads of the LLC, corporations persist. But there are key differences between S and C status.

If you have a corporation—one you formed or inherited—should it be S or C? What does this alphabet soup even *mean*? Articles of Incorporation filed with the Secretary of State are the corporation's birth certificate, but they do not say if the corporation is S or C.

All corporations are C corporations unless they file for S status. If you take no action, your corporation is a C corporation. Whether S or C, a corporation is entitled to limited liability. A corporation is a separate legal entity owned by its shareholders. It is ruled by a board of directors who elect officers to do day-to-day management.

But C v. S status is all about taxes. File a one page S election with the IRS and it will be taxed much like a partnership or LLC. The shareholders receive Forms K-1 and report and pay tax themselves. A corporation may be taxed as a C corporation for many years and then change to S status. Alternatively, by filing an S election upon initial formation, it may start life as an S and never be a C corporation.

The income from a C corporation is taxed twice. The corporation pays tax on its net income. Then, shareholders also pay tax on distributions. Income from an S corporation is taxed once at the shareholder level.

An S corporation can have no more than 100 shareholders, only U.S. citizens and resident aliens, generally individual shareholders, and a calendar fiscal year. If there are multiple classes of stock, only differences in voting rights are allowed. For most small businesses, these criteria are easy to meet.

Thus, if the owners are more comfortable with the corporate form than with an LLC, an S corporation can be a good choice. However, it is hard for existing C corporations to convert. An S corporation can face corporate tax if it was previously a C corporation and elected S status within the last 10 years.

Many of these rules can be avoided if you start out with an S corporation. To do this, file an S election with the IRS within 75 days of forming your corporation. How do you weigh the advantages and disadvantages between C and S on your facts?

Usually, C corporations are undesirable for small businesses due to double tax on income and on proceeds of sale. Besides, if you incur losses, you want to claim them personally. That would favor an S corporation.

Whether you have a C or S corporation, don't forget a buy-sell agreement. Without one, a closely held or family business can face financial and tax problems on an owner's death, incapacity, divorce, bankruptcy, sale or

retirement. For S corporations, buy-sell agreements are especially important since some share transfers can terminate an S election.

A buy-sell agreement can ward off infighting by family members, co-owners and spouses. It can keep the business afloat so its goodwill and customer base remain intact. It can avoid liquidity problems that often arise on these major events. One of the beauties of buy-sell agreements is that they are reciprocal. No one knows for sure who will be the first to go by death, disability or retirement. That makes negotiating these issues easier than you might think.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.