PERSPECTIVE

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Corporations, elections and buy-sells, oh my

By Robert W. Wood

What type of legal entity should you form for clients? It all depends, of course, but what should be your default? Whether you are a litigator, business lawyer or general practitioner, you probably have encountered this issue. If someone has a part-time or full-time business on their own and without a legal entity, he is a proprietor.

The income and expense from a proprietor's business goes on Schedule C to his personal tax return. Schedule C, it turns out, is the single most likely type of tax return to be audited by the IRS. That in itself can be reason enough to form an entity. Other reasons include concern for liability protection and allowing for multiple owners.

For many years, when an individual outgrew a proprietorship, a corporation was the norm for conducting business. Today, limited liability companies are the new normal. But in this column, I want to sidestep LLCs and stay with the corporate form. After all, despite the inroads of the LLC, corporations remain prevalent and all lawyers should know key differences between S and C status.

It all depends, of course, but what should be your default? Whether you are a litigator, business lawyer or general practitioner, you probably have encountered this issue.

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 (under subchapter "C" of the tax code) *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. Liability protection is one reason businesses incorporate.

Corporations have a structure people understand. 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 vs. S status is all about taxes.

File a one page S election with the IRS and the entity will be taxed almost like a partnership or LLC. That means the shareholders receive a Form K-1 and they 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.

If it never converts from C to S status, the corporation and its shareholders will be better off. They need not worry about the built-in gain tax on conversion from C to S (more about that tax below). Converting from C to S is regulated by the IRS. In contrast, S to C conversions are not.

The reason for this lack of symmetry is that 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 only once at the shareholder level.

An S corporation must generally have a calendar fiscal year and can have no more than 100 shareholders. They must generally be individuals and only U.S. citizens and resident aliens. 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, the accounting rules for S corporations are complicated, and it is difficult for existing C corporations to convert. An S corporation can face corporate "built-in gain" 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. Whatever you do, pay attention to the tax rules.

What's more, don't ignore mechanics either. 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 a world of 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, sometimes with disastrous tax consequences.

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. How much you need a buy-sell agreement depends on how many owners there are and who else might be waiting in the wings with a financial stake in the business.

One type of buy-sell agreement is a cross-purchase. If one owner dies, becomes disabled, goes bankrupt, etc., the other(s) can buy his share. With a redemption style agreement, the business *itself* makes the purchase so the owners don't individually go out-of-pocket. With either type of buy-sell, the price might be fixed, determined by appraisal or formula.

The price might be paid in cash or installments over time. There may be one price and terms for retirement, one for disability, and one for death. Insurance features prominently in many buy-sell agreements, for insurance can guarantee that there is cash available when the time comes.

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 reciprocal nature makes negotiating and agreeing on these issues easier than you might think.

Even though LLCs may be all the rage today, don't forget about corporations. When you form, encounter or advise them, pay attention to fundamental tax issues, including S elections. And for either C or S corporations, remember how important buy-sell agreements can be. Closely-held and family businesses will thank you.

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