1 S CORPORATION— THE UNIVERSAL CURE—MAYBE

WHAT IS AN S CORPORATION?

Ask this at the beauty parlor, barber shop, social club, or your next party. You will hear:

"It's a corporation that is taxed like a partnership."

"It's a partnership with limited liability that protects you from being sued."

"It's a tax-saving device that used to be attractive, but now the rules are so complicated that it's no longer viable."

"It's a device that enables lawyers and accountants to charge more fees."

All of these answers are, to some extent, true. However, each one also has much myth and some fable built in. Except for the tax area, S corporations are like any other corporations. In the tax area, they are more like partnerships, but there are significant differences. S corporations, their configurations, and their tax aspects can be quite complicated, and that can mean high professional fees. However, those complications are often unnecessary and are brought about because the owners of S corporations did not take time to learn the basic rules. This book is designed to help you stay out of such quagmires and run a clean, uncomplicated S corporation. We are going to help you weed out the myths and fables to enable you to make wise decisions regarding incorporation.

THE ALTERNATIVE FORMS OF DOING BUSINESS

The best way to understand S corporations is to know what they are not and why. To do that, we should look at the various legal forms of doing

business and why an S corporation may be your best choice (or, in some cases, not your best choice). Two short chapters cover this: This chapter describes each legal form in general; Chapter 2 covers the tax aspects of each. (Taxes are important enough to merit their own chapter.)

Sole Proprietorship

This is the form in which you operate if you do nothing to change your business to another form. That is, no one else is a part owner, you have not applied to your state government for a corporate charter, and you have not taken the steps to qualify as a limited liability company. In other words, one day you just hang out a sign that lets the public know that you sell platinum banana holders. That puts you in business. (Be aware, though, that even at this simple level, you will have some local government rules to worry about. Your city or county government will insist that you contribute to its treasury by at least purchasing an occupational license.)

Liability of a Sole Proprietor. If you follow this course of least resistance and hassle, you will have unlimited liability. If a banana falls off your holder onto the floor, and Aunt Emma slips on it, falls, breaks her hip, and successfully sues your banana holder business, you could end up having to sell your boat, sports car, and airplane in order to pay the judgment. If the award is exorbitant, you may even have to file for bankruptcy!

Transferability of a Sole Proprietorship. What if you want to sell the business or give it away to your child? This can be somewhat involved. What you sell are the machinery, desks, and other assets of the business. If the buyer is to assume the debts of the business, you'll need legal help to jump through the hoops.

Government Regulation of a Sole Proprietor. The bureaucrats will be prodding you no matter what form of business you choose. However, there is a little less hassle for a sole proprietor than for other business forms.

Partnership (General Partnership)

Like a sole proprietorship, this form of business often exists by default. If you and at least one other person decide to enter business together, you have formed a partnership. Who can be a partner? Almost any individual, corporation, limited liability company, association, government agency, another partnership, or any other legal or commercial entity. Even though your state or local government may expect you to register your partnership, the Internal Revenue Service (IRS) will recognize this entity as a

partnership even if it is not registered or recorded as such with any government authority.

Liability of Partners. As are sole proprietors, each partner is liable for the debts of the partnership, and the liability is what the lawyers call joint and several. In other words, if the business is unable to pay its debts (which might include judgments resulting from a successful suit by a customer) each partner has liability for all the debts of the partnership. For example:

> Doris, Eleanor, and Fred form a partnership. Doris is independently wealthy, but Eleanor and Fred have no investments and not much else that can be converted into cash. If the partnership falls on hard times, runs up debts of $1 million, and has only enough cash and other assets to pay $100,000 of the debts, the partners will have to cough up the other $900,000. Because Eleanor and Fred have no assets, Doris will have to pay the whole $900,000 from her resources.

Watch out for the spendthrift partner:

> What if Fred decides that the partnership could do more business if he could frequently fly around the world, contacting distributors of the product? So, he signs a contract for a long-term lease of an executive jet plane, obligating the partnership to monthly payments of $50,000. Now the debts of the partnership could total more than even Doris has in her investment account, wiping her out financially.

So, if you are in Doris' shoes, be wary of forming a simple, or general, partnership. Choose another form of business that avoids this unlimited liability.

Transferability of a Partnership Interest. If all the partners sell the business to others, the transfer is similar to selling a sole proprietorship, with the added complication of which partners get how much of the proceeds of the sale. If one partner wants to sell his or her partnership interest, there can be more complications. For instance, if one partner is older than the others and wants to retire, how much should that partner receive for the partnership interest?

> Because of your technical background, you have developed an efficient method of manufacturing platinum banana holders. However, you need some marketing help, so you enlist Elmo, your brother-in-law, who has a successful background in sales and marketing, plus a hoard of some cash that your business sorely needs. In exchange for his cash, expertise, and time, you give Elmo one-half the business. You have now established a partnership.
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> Your agreement with Elmo may be nothing more than an oral agreement. However, it's foolish to rely only on an oral understanding. What if your sister divorces Elmo? What if you and Elmo have a major disagreement as to how the business should be operated? What if Elmo states that he should own more than one-half the business because (he thinks) he has contributed more to it? Without a written agreement as to how the partnership may be split up, you may be in for some lengthy and expensive litigation.

The caveat here is that, at the formation of a partnership, the partners should draw up a partnership agreement that specifies the formula for valuing a partnership interest and how profits and proceeds of a sale of the business will be allocated among the partners.

Limited Partnership

The *limited* in the term *limited partnership* refers to the limited liability conferred on some of the partners, who are called limited partners. If properly set up, they cannot lose (be at risk for) more than they have invested in the partnership.* In order to create this limited liability for certain partners, specific rules have to be followed. The rules include:

1. At least one partner must be designated as a general partner, and that partner generally does not have limited liability.
2. An individual or entity who is to be a limited partner should be so designated in the partnership agreement and in any document filed with the state.
3. The limited partners can take part in the management of the business of the partnership to only a limited extent. Exactly how much of a management role they can have varies with the laws of each state.
4. The limited partnership must be registered with the proper state authority.

Limited partnerships are currently seldom used except in special circumstances. Why? The recent development of limited liability companies has created a business form that avoids some of the complexity of limited partnerships. Specifically, it avoids the confusion over the requirement that some partners have unlimited liability while other partners are protected by limited liability.

However, one of the circumstances that favor a limited partnership is the *family limited partnership*. Setting up one of these can significantly reduce federal estate taxes for an owner of a business with a worth of $1 million or more.

Corporation

A corporation is a separate entity, defined and created by a government. It is like another person, although it does not have the emotional needs that humans have. Neither does it have the same health problems and mortality humans have, although you can find corporations that are sick (financially), and many do eventually die. Theoretically, though, corporations can live forever.

The government does not create corporations willy-nilly, but only

*A limited partner could be at risk for more than his or her investment if that partner signs a note to the partnership or guarantees an obligation of the company (as a bank loan).

when one or more persons ask the government to authorize, or charter, a corporation. In the United States, most corporations are chartered by state governments. A few are chartered by the federal government, but these are created for specific needs of the federal government rather than for meeting the requirements of individuals.

Corporations that are formed for the purpose of earning profits* (it is hoped) are owned by stockholders. After a state charters a for-profit corporation, the stockholders fund the corporation by buying shares of stock from the corporation.

> Four people set up a corporation to sell platinum letter openers. They anticipate that $10,000 will finance the inventory, advertising, and other initial expenses. They might, in their request to the state for a corporate charter, seek authority for the corporation to issue 50,000 shares with a stated value of one dollar per share. After the charter is issued, they then each buy 2,500 shares at one dollar each. The other 40,000 shares that are authorized are kept, as unissued stock, by the corporation, but they are available to be sold if more funds are needed later from the existing or additional owners of the corporation.

Although the operation of a sole proprietorship or partnership is almost always managed by the proprietor or partners, the corporation form provides an easy way for investors (the owners or stockholders) to hire others to manage the business. Historically, the stockholders hold meetings, at least annually, at which they elect several individuals to be directors of the corporation. These directors meet and elect corporate officers (president, vice president(s), secretary, and treasurer) who will actually manage the business. Generally, these directors and officers do not have to own any stock in the corporation, although they usually do.

The terms of chief executive officer (CEO), chief financial officer (CFO), chief operating officer (COO), and so on that have come into popular use are not formally recognized as pertaining to corporate officers, although they may be the same people. The popular terms are just more descriptive of the duties of the individuals than are president, vice president, and so on.

Obviously, this business of electing directors who elect officers works for large publicly held corporations. However, for Cedric, who is incorporating his bake shop, it's pretty ridiculous. Cedric will own all the stock, he will elect himself and other family members as directors, and they will elect Cedric as president. In the past few years, enlightened state legislatures have recognized this absurdity and passed laws that allow, in smaller corporations, the stockholders to directly designate a president, who can also act as all the other officers. Check with the proper authority in your state as to whether you can use this streamlining in setting up a corporation.

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*Not all corporations are incorporated for the purpose of conducting a profit-making business. Some government operations and many charities are operated as nonprofit corporations. As nonprofit entities, they do not issue stock or have owners.

Liability of the Owners of a Corporation. The owners (stockholders) of corporations have limited liability that the state confers on them. Although a corporation may be sued, and, if the suit is successful, it may lose all of its assets and be forced into bankruptcy, the stockholders of the corporation would not lose their assets (other than the corporation's stock that they own). At least that is the theory. In real business life, directors and officers of corporations are often sued, along with the corporation, for damages allegedly caused by the negligence of the officers. That's why, in addition to incorporating a business, the owners need liability insurance to protect their personal assets. So why bother to incorporate your business?

> Assume you are one of the four people who are stockholders and officers in the platinum letter opener business. A customer, William, buys one of the letter openers, trips over a curb on the way home, and in the process of falling manages to stab himself. The cost for the ambulance, surgeon, hospital, needle, and sutures is $25,000. William sues your corporation for the $25,000 plus $500,000 for pain and suffering. He wins a judgment of $200,000, but can collect only $10,000 from the corporation. (That's all the money the corporation has.) However, William also sues you and the three other officers, but culpability and the resulting liability of the four of you are far harder to prove in court. The chances are good that you will not be found liable, and if that is the case, you have saved yourself much grief by incorporating. Had you not done so, the four of you would have had to come up with the money to pay the $200,000 (or file for bankruptcy).

In other words, the risk of personal liability is far less for a corporate officer than for a sole proprietor or partner.

Transferability. Another reason for incorporating is that it bundles up your business in a tidy package that makes selling all or part of the business to other people an easy task. To transfer ownership of a corporation, all that must happen is that one owner sells his or her corporate stock to another new (or existing) owner. A sale of a sole proprietorship or partnership is generally much more complicated, particularly in the tax area. (More about that later in the book.)

Government Involvement. Because corporations are a creation of the state, it has carte blanche authority to regulate them and, unfortunately, levy whatever fees and taxes please the legislature. Again, check with your state's authority about fees and taxes. If you are starting a very tiny business, you might be well advised to avoid this additional expense by starting as a sole proprietor. Take the money you save on fees and taxes and use it to buy liability insurance for your business.

S Corporations. What's the difference between an S corporation and a plain-vanilla corporation? Except for income tax issues, there is none. You turn a C corporation into an S corporation by filing a form with the IRS, telling the folks there that you want your corporation to be an S corporation. Then, when the IRS acknowledges in writing that your corporation

will be taxed or not taxed according to the rules in Subchapter S of the Internal Revenue Code, you really do have an S corporation. Sounds simple, but there are some picky rules involved, as covered throughout this book.

You may hear both the terms S corporation and Subchapter S corporation. Here again, there is no difference. These interchangeable terms came about this way:

When the concept of an S, or Subchapter S, corporation was enacted into our federal income tax code about 50 years ago, the pertinent section of the law was titled "Subchapter S." These small business corporations then became known as Subchapter S corporations not because the tax code itself gave them that name, but because tax professionals referred to them by the section of the law that instituted them. When the rules relating to these corporations were revised (read, made more complicated) in 1982, Congress recognized this name, shortened it to just "S corporations," and included that appellation in the tax code. In other words, the correct and most often used name now is S corporation. However, there is no law that forbids you to say "Subchapter S," and you can still find tax professionals who use that term. (The tax code sections covering S corporations are still in Subchapter S of the Internal Revenue Code.)

While the subject of chapters of the Internal Revenue Code is at hand, I should mention Chapter C of the IRC. That is the chapter that covers regular corporations that do not receive S corporation tax treatment. In the rest of this book and in other tax literature you'll read about "C corporations" and "S corporations," meaning conventional corporations and corporations that have S tax status.

Limited Liability Company (LLC)

This is a relatively new-kid-on-the-block form of business operation. Like corporations and limited partnerships, a limited liability company is created by the operation of state law. It is similar to a corporation, in that all the owners are protected by limited liability. However, the rest of the attributes are similar to those of a partnership. Although it would not be completely accurate, a limited liability company could be defined as a partnership in which all the partners have limited liability. The emergence of LLCs is, obviously, the reason that general and limited partnerships are much less used today. There is much more discussion in Chapter 6, which is devoted to this form of business structure.

Estates and Trusts

A discussion of entities would not be complete without a mention of estates and trusts. The only way to create an estate that operates your business is to die. Because this is not a desirable choice for most of us, we'll leave that subject to books on administration of estates.

Trusts can also be established by the act of dying, if the trust has been planned for and documented ahead of time, or trusts can also be estab-

lished during a lifetime and can operate a business, be a partner, and sometimes be a corporate stockholder. However, the current income tax rates for trusts are not attractive, so there is no income tax reason to set one up. There may be estate-tax reasons to set up trusts, and there may be valid nontax reasons, such as providing for a spendthrift heir or avoiding probate.

SUMMARY

Table 1.1 is a summary comparison of the types of business forms we have discussed. Note that C corporations and S corporations are described in the same column, because the difference between them is in how they are taxed. That subject is covered in Chapter 2.

TABLE 1.1 Summary of Types of Business Organizations

	SOLE PROPRIETORSHIP	GENERAL PARTNERSHIP	LIMITED PARTNERSHIP	CORPORATION (C OR S)	LIMITED LIABILITY COMPANY (LLC)
Eligible owner	Any individual	Individuals, corporations, LLCs, other partnerships, trusts, estates	Individuals, corporations, LLCs, other partnerships, trusts, estates	Individuals, corporations, LLCs partnerships certain trusts, some estates[1]	Individuals, corporations, partnerships, other LLCs, trusts, estates
Evidence of ownership of business	Signs, letterhead, advertisements, city or county business license	Partnership agreement, written or oral	Partnership agreement, written as specified by state law; registration with state	Charter issued by state to corporation; stock certificates issued by corporation to stockholders	Agreement between owners written to comply with state law; registration with state
Number of owners	One individual	Any number	Any number	Any number (but see Chapter 2 as to limitation for S corporations)	Any number
Personal liability of owners	Unlimited	Unlimited	Limited for limited partners; unlimited for general partners	Limited to amount of investment (unless corporate veil can be pierced)	Limited for all owners (unless veil can be pierced)
Ease of entering organization	Very easy	Easy to start small partnership; later entry determined by existing partners and partnership agreement	Complex for organizer of partnership; purchase of limited partnership interest usually easy	Complexity varies with size of operation, but must comply with state law and administrative procedures	

[1]S corporations may be owned only by individuals, certain trusts, and estates.

(Continued)

TABLE 1.1 *(Continued)*

	SOLE PROPRIETORSHIP	GENERAL PARTNERSHIP	LIMITED PARTNERSHIP	CORPORATION (C OR S)	LIMITED LIABILITY COMPANY (LLC)
Continuity of life	Until owner closes business, sells assets, or dies	Usually until more than 50% of ownership changes, but varies with state laws and partnership agreements	Usually until some date or future event specified in partnership agreement	Forever, or until stockholders agree to merge, dissolve, or sell corporation	Usually until some specified date or future event; variation between states as to requirement
Management	Either owner or hired manager (with no ownership interest)	Some or all of partners or hired managers	General partners(s); management by limited partners may be limited by state law	Stockholders generally elect board of directors, which appoints corporate officers to manage business	Members (owners) of the LLC or hired managers