Is an S corporation the best choice of entity for your business?

Are you thinking about launching a business with some partners and wondering what type of entity to form? An S corporation may be the most suitable form of business for your new venture. Here's an explanation of the reasons why.

The biggest advantage of an S corporation over a partnership is that as S corporation shareholders, you won't be personally liable for corporate debts. In order to receive this protection, it's important that the corporation be adequately financed, that the existence of the corporation as a separate entity be maintained and that various formalities required by your state be observed (for example, filing articles of incorporation, adopting by-laws, electing a board of directors and holding organizational meetings).

Anticipating losses

If you expect that the business will incur losses in its early years, an S corporation is preferable to a C corporation from a tax standpoint. Shareholders in a C corporation generally get no tax benefit from such losses. In contrast, as S corporation shareholders, each of you can deduct your percentage share of these losses on your personal tax returns to the extent of your basis in the stock and in any loans you make to the entity. Losses that can't be deducted because they exceed your basis are carried forward and can be deducted by you when there's sufficient basis.

Once the S corporation begins to earn profits, the income will be taxed directly to you whether or not it's distributed. It will be reported on your individual tax return and be aggregated with income from other sources. To the extent the income is passed through to you as qualified business income, you'll be eligible to take the 20% pass-through deduction, subject to various limitations. Your share of the S corporation's income won't be subject to self-employment tax, but your wages will be subject to Social Security taxes.

Are you planning to provide fringe benefits such as health and life insurance? If so, you should be aware that the costs of providing such benefits to a more than 2% shareholder are deductible by the entity but are taxable to the recipient.

Be careful with S status

Also be aware that the S corporation could inadvertently lose its S status if you or your partners transfers stock to an ineligible shareholder such as another corporation, a partnership or a nonresident alien. If the S election were terminated, the corporation would become a taxable entity. You would not be able to deduct any losses and earnings could be subject to double taxation — once at the corporate level and again when distributed to you. In order to protect you against this risk, it's a good idea for each of you to sign an agreement promising not to make any transfers that would jeopardize the S election.

Consult with us before finalizing your choice of entity. We can answer any questions you have and assist in launching your new venture.