

## **Subchapter S Corporations**

One of the first things a new business owner must decide is the type of legal structure the business should take. There are a variety of business forms available in Texas and these can be generally categorized as sole proprietorships, partnerships, corporations, and specialized entities (professional corporations, LLCs, etc.). Each form has its own advantages and disadvantages and choosing the proper form depends upon the goals of the business owner.

There are two general corporate forms, the C corporation and the S corporation. Both have some characteristics in common, such as shareholder ownership and the requirement that they file with the state for corporate status. The C corporation is a traditional corporate form. The S corporation is a federally created form minimizing the tax liabilities for the owners and is specifically designed for small businesses.

### **Advantages**

The biggest advantage of an S-corporation is “flow-through” taxation. For simplicity, you can think of the traditional corporation as an individual for tax purposes. Similar to an individual’s income tax, money coming into the corporation is taxed by the federal government (the state government and local government also jump on the tax bandwagon, but for purposes of this discussion, I’ll stick to the federal implications).

The problem is that having money in the corporation does not help the owner pay his bills, so he will receive a disbursement from the corporation as dividends or salary, if he has a position in the company. The owner then has to pay personal income taxes on the receipt of that money. So, money is taxed when received by the corporation, then again when paid to the individual.

The S corporation was created to combat this “double taxation” problem created by the traditional corporation form. Under the S-corporation guidelines, the corporation is not taxed separately, but rather the individual owners are taxed based upon the revenue received by the corporation and paid out to them. The corporation itself is exempted from the first step found with double taxation. Essentially, the government has recognized the importance of small businesses with limited ownership, and limited the tax penalties involved with a corporate status.

The beauty of the S corporation is that this tax advantage doesn’t take away the protection from legal liability afforded owners. Corporations are still treated as individuals for purposes of assessing liability for corporate actions. In most cases, the corporation is going to be held responsible for actions taken during its business operations. In the case of litigation against the business, the corporation’s assets are used to satisfy a judgment and the owner’s personal assets are protected. Contrast this to a partnership or sole proprietorship where the owner’s assets may be called into play to satisfy a judgment against the business.

A final advantage is that the S corporation continues to exist in perpetuity. A sole proprietorship ceases to exist upon the death or withdrawal of the owner. Likewise, a partnership is generally dissolved upon the withdrawal of a partner. Corporations, once again treated like separate individuals, can continue to exist beyond the withdrawal or death of the owner. This allows for a certain flexibility when it comes to transfer of the ownership of the business not necessarily found in other business forms.

But, as with every form of business, there are some disadvantages to the S corporation.

### **Disadvantages**

Ownership of the S corporation is somewhat limited. In order for the S corporation to maintain its tax status, the corporation generally can not be owned in the majority by another corporation or some types of trusts. Since the idea of the tax advantage is to provide benefits to individuals, the ownership of an S corporation by another similar entity, would defeat the purpose.

Whenever a corporate form is chosen, it will be necessary to maintain certain corporate formalities in order to keep the corporate status in place. These formalities can be problematic and failure to meet these requirements, may result in the business being declared not a corporation and therefore losing the protection afforded to the owner. An S corporation is no different.

### **Corporate Formalities**

The following is a short reminder list of the corporate formalities which will be required to achieve and maintain S corporation status.

1. The Articles of Incorporation must be filed with Secretary of State along with a filing fee (currently \$300.00).
2. Upon return of the Certificate of Incorporation from the State of Texas, an initial meeting of the shareholders must be conducted, at which the directors and officers are elected, and corporate bylaws are adopted.
3. Apply for a Federal Tax Identification Number using Form SS-4 and mail to the regional IRS office, if you have not already done so.
4. File IRS Form 2553 electing Subchapter S status for the corporation.
5. At least once a year, hold an annual meeting of the directors and shareholders to elect directors and officers for the upcoming year and to take corporate action as needed. The corporate Secretary should create a record of the annual meeting using a formal written corporate minutes and maintain those minutes with the corporate documents.
6. Stock certificates do not have to be issued for stock ownership, but may be issued if desired by the purchasing party. Stock transfers should be maintained in the stock ledger by the corporate Secretary.
7. Maintain a separate corporate bank account in the name of the corporation.

8. Ensure that personal expenses are not paid using the corporate bank account. Only valid corporate expenses should be paid from the corporate account.
9. When purchasing assets for business use, make sure to acquire them in the corporate name. For example, if a vehicle is purchased for the use of the corporation, then the vehicle should be titled and insured in the name of the corporation.
10. Any legal documents which are entered into on behalf of the corporation should be signed by a corporate officer or employee specifically designated by the directors of the corporation by a board resolution. Any person signing on behalf of the corporation should make sure to designate their position in the corporation with their signature (ex: John Doe, President of XYZ Corp.).

This information is intended as general legal advice and may not apply to your particular situation. If you have any legal questions you would like answered in this column or ideas, please forward them to me at [Edward@erbarrettlawoffice.com](mailto:Edward@erbarrettlawoffice.com), fax number (214) 722-0025 or by mail at the Law Office of Edward R. Barrett, 4451 FM 2181, Ste. 100, PMB 125, Corinth, Texas 76210.