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NebFact



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Setting Up Your Own Business: The "S" Corporation

by Paul H. Gessaman, Extension Economist

This is one in a series of **NebFacts** providing information on the principal forms of business organization used by small businesses. A broad overview of the advantages, limitations, and tax implications of each form of business organization is included. Titles in the series are listed at the end of each NebFact.

Your need for legal and tax advice: While the information contained in this document is thought to be accurate, it should not be used as a substitute for legal advice on matters related to business organization, taxation, estate planning, or other business and financial management matters. Consult with your legal and tax advisers before making decisions.

Form of business organization:

An "S Corporation" is a corporation that elects to be taxed under Subchapter S of the Internal Revenue Code (enacted in 1958 and periodically amended) and receives IRS approval of its request for Subchapter S status. As a legal entity (an artificial person), the S corporation is separate and distinct from the corporation's owners (the stockholders). Under Nebraska incorporation law, there is no distinction between a C corporation and an S corporation. However, the two type of corporate entities are subject to differing federal and state tax treatment.

Eligibility for S corporation tax status is based on compliance with IRS regulations regarding the number and characteristics of stockholders, type of stock issued, and other characteristics specified in the regulations. Principal characteristics of S corporation taxation are briefly discussed in this document.

An S corporation can issue only one class of stock. Prior to January 1, 1997, an S corporation can have no more than 35 stockholders. In tax years beginning after December 31, 1996, the maximum number of eligible stockholders is increased from 35 to 75. Nonresident aliens, self-directed IRAs, some types of corporations, partnerships, and some types of trustees presently **cannot** hold stock in an S corporation and will continue to be ineligible after December 31, 1996. However, in tax years beginning after that

date, a qualified retirement plan trust or a 501(c)(3) charitable corporation may be S corporation stockholder. Other restrictions on stockholder eligibility apply under some circumstances. Your attorney can determine whether any of these restrictions apply in your situation.

After December 31, 1996 a testamentary trust can hold S corporation stock for up to two years from the date of the grantor's death. (Prior to January 1, 1997, the holding period is 60 days.) Generally, this change will make it easier to settle an estate where a testamentary trust is established and receives S corporation stock in the estate settlement process. Consult your attorney for advice and guidance on applications of this longer holding period to the administration of any testamentary trust that receives S corporation stock

As a separate legal entity, the corporation finances and records are established and maintained completely separate and distinct from the finances and records of the stockholders. Through a resolution adopted at a stockholders meeting held in accordance with the bylaws of the corporation, one or more officers or employees of the corporation are authorized to conduct business on behalf of the corporation. The resolution typically includes an authorization with specified limits to borrow and repay funds as needed for business operations. Credit arrangements are made in the name of the corporation with loan documents signed by the authorized person or persons after the lender has received a certified copy of the authorizing resolution. If the corporation is newly formed, small (has few assets), or has a limited record of credit use, it's likely that a lender will require personal guarantees by one or more officers or stockholders before approving a credit application received from the corporation. If personal guarantees are given, the signer(s) usually have unlimited liability for the debts of the corporation.

The Corporate Charter includes information on the purpose(s) for which the corporation is organized and the life of the corporation. (A corporation often has perpetual life.) Bylaws of the Corporation are the "rules" for conducting the organizational life of the corporation.

Moderate legal costs are incurred in setting up a typical S corporation and annual costs are incurred for stockholders meetings, tax return preparations, and preparing other yearly reports and summaries as needed for management and as desired by stockholders. Public notice of the formation and continued operation of a corporation is required and is accomplished through filings with the Secretary of State's Office.

Advantages of the S Corporation:

Creation of the corporate shield that, in the absence of personal guarantees, limits the liability of stockholders to their capital investment in the corporation and the usefulness for estate planning purposes of the corporate form of business organization are frequently cited advantages of forming an S corporation. Other advantages include:

- The independent life of the corporation makes possible its continuation, and the relatively undisturbed continued operation of the business regardless of incapacity or death of one or more stockholders.
- Fractional ownership shares are easily accommodated in the initial offering of stock.
- The purchase, sale, and gifting of stock make it possible to have changes in ownership without disturbing the corporation's ability to conduct business.
- The requirement that the corporation's finances and records be separate from the finances and records of stockholders reduces the risk of unrecognized equity liquidations.
- With only a few exceptions, under the Subchapter S election for taxation as a partnership the S corporation pays no income taxes and corporation income or loss is passed through direct to the

stockholders.

- To the extent the corporate shield is maintained and other investments and savings of the stockholders are not at risk, the personal life of stockholders is simplified.
- The annual meetings of stockholders and consultations with legal counsel can provide stimulus for improved communication within the stockholder group (often a family group) and can provide more comprehensive guidance for management.
- Depending on the corporation's business record and the policies and practices of prospective lenders, access to credit and the ability to secure needed resources may be improved.
- Earnings representing "return on investment" (interest, rental payments, etc.) are not subject to self-employment tax as long as stockholder-employees receive adequate compensation for labor and management of the business.

Limitations of the S Corporation:

As a corporate entity entitled to taxation as a partnership, some limitations have been placed on who can be a stockholder of an S corporation. Consult your legal adviser regarding the possibility that these restrictions may apply in your situation. (See "[Your need for legal and tax advice.](#)")

Other limitations of the S corporation include:

- Lenders may require personal guarantees from corporate officers as a condition of supplying credit, thus negating the limitation of liability.
- Conflicts or disagreements among the stockholders (usually a small group of persons) may immobilize decision making.
- Restrictions on the sale of stock and/or buy-back agreements included in the bylaws may prevent minority stockholders from being able to recover the value of their investment in the corporation.
- Through the processes of gifting and inheritance, stock ownership can become divided among many persons who are not active in the business and they may become a voting block that does not support needs and decisions believed desirable by managing stockholders.
- Over time, corporation paid benefits for stockholder-employees may become costly and exceed the ability of the business to pay.
- Employment benefits such as life insurance, health insurance, and housing costs are taxable income to stockholder employees with 2 percent or more stock ownership and to employees who are directly related to persons owning 2 percent or more of the corporation stock.
- If appreciated assets are owned by the corporation and the corporation is dissolved, significant income taxes on the appreciation amount will be generated.

The corporate shield of limited liability may be lost:

- When corporate formalities are not followed — that is, when director and shareholder meetings are not held and minutes of such meetings are not kept.
- When corporate assets are treated as personal assets — for example, when a corporate vehicle is used for family vacation and the corporation is not reimbursed for the nonbusiness use.

When limited liability is lost, shareholders become personally liable for any corporate legal or financial obligations. In addition, if corporate income tax returns are audited, failure to observe corporate formalities or treating corporate assets as personal assets can result in loss of corporate income tax deductions and levying of penalties and interest on taxes assessed for previous years.

Tax implications — general:

All real and personal property held by an S corporation is taxable to the extent set by Nebraska law. Corporate income or loss, including capital gains, pass through to the stockholders, and is treated as income to the receiving individuals. In the same manner as partnership income, S corporation income passed through to stockholders is subject to state and federal income tax, but is not subject to self-employment tax when employee-stockholders receive adequate compensation (salaries) for their labor and management input to the business. Pay of corporation employees (salaries) are subject to payroll taxes in the same manner as is the case for employees in any other type of economic activity.

Assets of the corporation generally are retrieved to individual ownership only through transactions that generate taxable income. Sale of stock establishes the market price as the purchaser's tax basis for the stock, but does not increase the tax basis of assets of the corporation. Death of a shareholder may result in a "step-up" of the tax basis of his or her corporation stock, but does not increase the tax basis of assets held by the corporation.

If the corporation is dissolved when it owns assets that have appreciated in value (usually land, buildings, and/or equipment), federal income tax will be due on the asset appreciation amount even though the assets have not been sold. For this reason, many management advisers and estate planners recommend holding title to land in an entity separate from the corporation, — for example, in individual ownership or in ownership by a limited liability company. When this is done, the corporation rents the land from the individual or noncorporate entity. Generally, this approach is useful only when the value of fixed assets is relatively large or there is good reason to believe they will experience significant appreciation in value.

Gift tax and estate tax implications:

All aspects of the gift tax, estate tax, and inheritance tax apply to the receipt of corporate stock by gift or inheritance. Tax amounts are calculated on the value of the stock included in the gift or inheritance. Gifting of stock to utilize the nontaxable gift allowance of up to \$10,000 per recipient per year (up to \$20,000 for joint gifts by husband and wife) can be easily accomplished. Estate planning can provide a plan for minimizing the legal and tax costs of orderly transfer of corporate stock and/or noncorporate business or personal assets to successors. If you are considering gifting or other transfers of stock or other assets, be certain to secure and follow the recommendations of your legal and tax advisers when planning and implementing the gift or transfer.

Cooperative Extension publications in this series:

- [NF 96-253 *Setting Up Your Own Business: The Sole Proprietorship*](#)
- [NF 96-254 *Setting Up Your Own Business: The Partnership*](#)
- [NF 96-255 *Setting Up Your Own Business: The "S" Corporation*](#)
- [NF 96-256 *Setting Up Your Own Business: The "C" Corporation*](#)
- [NF 96-257 *Setting Up Your Own Business: The Limited Liability Company*](#)

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