

CORPORATE STRUCTURE: C corp vs. S corp

by Rudd McGary and Ed Wandtke

Many of you will be shocked by the impact on your personal taxation this year.

With the changes in the Tax Reform Act of 1986 and the allowance of businesses and individuals to change from the traditional corporate structure "C corp" to the alternate corporate structure "S corp," many closely-held companies changed to S corporations. That way, they could take advantage of the more favorable tax rates.

But many of those people didn't know some of the alternate consequences of that action. This knowledge will come in the form of increased taxes for 1987 and possibly even higher taxable income in 1988. Was this change in corporate structure the right move for your company?

The benefits

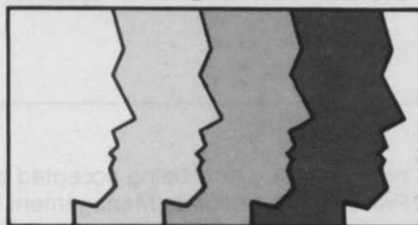
First, let's look at some of the benefits initially heard by you that led to your changing the form of the corporate structure from a C corporation to an S corporation:

1. Ability to have all income taxed at the lower personal income tax rates for individuals because of now operating under an S corp structure.
2. Avoiding the possible double tax on income passed to you in years after it was earned by the C corp.
3. Protecting your company and your personal assets from any attachment by possible creditors.



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4. Ability to establish more favorable retirement benefits for you as the owner of the S corp.
5. Avoid double taxation in the event you decide to sell the company.

The negatives

What are some of the potential negative aspects of switching to an S corp?

1. An S corporation cannot be acquired by a C corporation in the event of a sale of the company.
2. Pension or retirement plans that are discriminatory will be an unallowable deduction for the C corporation.
3. Transfer of the company to another set of owners will be more cumbersome in the event the current owner desires to maintain an equity position in the company when it is owned by the new operators.
4. All new S corporations will need to adopt a calendar year reporting period.
5. All new S corporations will report their financial results on the accrual accounting system.
6. Any C corporation that converted to an S corporation in 1987 because of the tax law change is prohibited from returning to the C corporation structure for five years.
7. If retention of equity in the company is required to grow the company, electing the C corp structure is more tax wise advantageous.

At first glance, the new tax law changes switching to an S corporation look favorable. But, upon closer use of the new corporate structure you may find that you will not really achieve

the objectives you had in mind when you made the change.

Get answers

Get the answers to the following questions before you make your decision to switch the form of the corporation.

1. What tax rate are you personally in now and what would be your corporate rate if you were in a C corp structure?
2. Do you or other stockholders individually have an alternative minimum tax issue?
3. Do you have any inactive stockholders?
4. Would you pay dividends if the company had extra earnings?
5. Do you plan on raising capital through the issuance of shares of stock?

When should you avoid electing or switching to an S corp status?

1. If the business has losses and inactive stockholders.
2. NOL (net operating losses) cannot be transferred to or used by an S corp.
3. Fringe benefits are limited for stockholders who own more than two percent of the outstanding share of a company.
4. If the company plans on buying another company or forming a subsidiary of its own.
5. Convertible debt or preferred stock cannot be sued if a company is an S corp.

Summary

In the future, consult with your certified public accountant and lawyer when there are new tax changes. Lower taxes may be the desire of everyone, but if that limits the future options of the corporation, it may not be worth it.

Meet with your advisors before you undertake any change in the corporate structure of your business. Discuss your future objectives for the company and how you anticipate handling the ownership of the business.

All that sparkles is not gold; likewise, an S corporate form may not be the right form for your corporation. **LM**