Subchapter S: Some Myths, Realities and Practical Considerations

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STARTING UP:
Practical Advice for Entrepreneurs

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Subchapter S: Some Myths, Realities and Practical Considerations

I have often had entrepreneurs tell me with great confidence that they either do or do not want to set up their venture as a Subchapter S corporation. Equally often when I ask them why they want to take that course of action I find they don't really understand what is involved.

What is a Subchapter S Corporation? A Subchapter S corporation is a corporation, which meets the requirements for and has made a proper election to be taxed under Subchapter S of the Internal Revenue Code. Although its taxation is a creature of the tax code it is not a corporation, which is organized under the Internal Revenue Code. This seems to be a popular misconception among entrepreneurs.

Why Elect Subchapter S status? The primary perceived benefit is one layer of tax. A corporation like IBM is taxed under "Subchapter C" of the Internal Revenue Code. IBM pays taxes on its net profits and then the IBM stockholders pay taxes when the profits are paid out to them. In contrast, in a Subchapter S corporation the corporation's net profit or net loss is deemed distributed to the stockholders, who have to include it on their individual tax returns whether or not they actually receive cash.

It used to be a relative no brainer to elect S if you qualified. The highest corporate rates were higher than highest individual rates. So if the corporation elected Subchapter S status the overall situation resulted in less current tax. After the tax changes in the early Clinton years, the highest individual rates (in the 40% range) are now higher than highest corporate rates (generally 35%) and as a result the venture (corporation and stockholders combined) may actually pay more currently if the venture is profitable and elects S status. Now you have to look at the venture's likely exit strategy. If the company can be sold through an asset sale in a few years then with a cash flow model you can determine the net present value of paying incrementally higher taxes currently in order to pay only one layer of tax on "big hit" sale at end, assuming the tax rules don't change in the interim. If the exit strategy is a tax-free stock-for-stock acquisition of your company by a public company then it might not make sense to have the stockholders pay a larger current tax on profits. However, for most high tech growth companies involved in product development there may not be any net profit during the development stage so being an S Corporation will not create a current tax payment situation.

With one layer of tax, losses as well as profit flow through. There are a number of complex rules about how those losses can or can't be used currently to offset other income of the stockholders. When all is said and done your outside private investors will most likely not be able to use their share of the losses currently and the only time the Founders/management team will effectively be able to use the losses currently is if (a) they have made actual cash investment in the venture, (b) they own a large enough percentage of the venture so that the losses allocated to them are useful, and (c) they have other income (e.g. a working spouse) to use the losses against.

The net result is that for most high growth technology ventures the primary benefit to Sub S status is to avoid two layers of tax on sale of the venture in an asset sale transaction. Still this is useful.

Becoming a Subchapter S Corporation. So how does a corporation receive the benefits of Subchapter S status? First an S corporation must at all times qualify. It can have no more than 75 stockholders who in general must all be human beings. A few special types of trusts are permitted as stockholders but you cannot have any corporate stockholders, partnership stockholders etc. Because of this, most S corporations lose their S status when venture capital firms invest. No stockholder can be a "nonresident alien"- e.g. an S corporation cannot have as a stockholder a French citizen living in Paris. For all practical purposes only foreigners living in the United States and having "green cards" will meet the resident "alien" test. The corporation must have only one class of stock (although two or more classes are allowed if the only difference between the classes is in voting rights).

Second, the qualifying corporation must elect to be taxed under Subchapter S. In general to be effective for a year the election must be filed with the IRS on or before the 15th day of the third month of the taxable year. So for example, a corporation formed on June 1, 2004 would have to file the election by August 15. The election is a simple one page form that must be signed by all stockholders. This creates a practical problem if the stock ownership has not been worked out or if the percentages are agreed but the stockholder agreement issues haven't been finalized. Once Subchapter S status is elected you can switch back to regular Subchapter C status but you can't flip-flop back and forward and there are a number of technical rules which apply.

Some Practical Issues. With Sub S you are more involved with your investor stockholders' tax situation. Every tax season you have to supply them with "K-1"s reports so they know how to treat their investment on their tax returns. If you don't get these out in time for April 15, your stockholders will have to file for extensions for their returns or file amended returns. Some people don't like loose ends and will be annoyed if you delay their April 15 filing schedule. With some limited exceptions a Subchapter S corporation must have a calendar tax year. This means that you will be dealing with your accountants during their busiest season which may result in extra costs or the foregoing of discounted billing, e.g., some accountants give lower rates to companies who have work that does not need to be done during the "peak season". In addition there is some level of general extra expense involved in trying to work within the Subchapter S rules.

Alternatives to Subchapter S. It is possible to achieve the single layer of tax through the use of a partnership form of doing business. However there is potential personal liability on the part of the partners even if the limited partnership form is used and there are some operational problems in running a business in partnership form. Another option is to set the business up as a "limited liability company", which can be structured like a partnership to give single layer of tax treatment and provides limited liability to the owners of the business.

However, Massachusetts is one of only a handful of states that doesn't recognize the limited liability company form of doing business. So for our Massachusetts readers, you don't need to know about this yet, however, you may want to call your state senator or representative and ask him or her why the state that started the American Revolution is so far behind on this one. [Note: Massachusetts has now adopted the LLC form- see the column "Is An LLC For Me?"]

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