Is the S-Corp Right for Your Family Owned Business?

Do you run a family-owned business? Is personal liability a concern? Are you looking for ways to transfer wealth to your children? Forming an S corporation as a vehicle for your family-owned business may be a great business and estate planning option.

In California, the S corporation can be formed by electing to be taxed under Subchapter S of the Internal Revenue Code. In affect, the corporation will be taxed like a partnership. Both income and expenses are “passed through” directly to the shareholders. Income and expenses are taxed at the shareholder’s individual tax rate but corporate income is not taxed. Therefore, income from an S corporation is taxed only once. The S corporation gives shareholders of a family-owned business the advantages of the corporate form—including personal or centralized management and limited personal liability—while avoiding double-taxation.

S corporations, partnerships and LLCs, share many tax attributes, but there are some significant differences which make an S corporation well-suited as an investment vehicle for the family-owned business.

First, S corp. shareholders do not incur personal liability for business debts. This is a risk however, for general partners as well as limited partners who take an active role in their business. Shareholders of a family-owned S corporation may also benefit from the entity’s structure itself. For example, to be formed in the first place an S corporation requires as low as only one shareholder. However, even a partnership requires at least two owners. Next, the structure of an S corporation maintains continuity of ownership and management. When the ownership interests of a partnership or LLC are sold or otherwise transferred, the family-owned business entity may necessarily be terminated or extinguished. In addition, shares of an S corporation are more easily transferred than their counter-part interests of a general partnership or an LLC, which usually must be restricted to preserve pass-through tax treatment.

Finally, in the S corporation family members maintain management and control of the S corporation. In the case of general partners, they must share management and control powers, and limited partners usually have no power at all. The LLC can have centralized management, but cannot switch or change the management structure without amending its articles first. S corporation shareholders have maximum flexibility to manage, or, not to manage at all. This management structure provides great benefit to a family-owned business where the family may desire to retain control over the business they have worked so hard to build.

The S corporation can also be effectively used as a family tax planning tool. Parents in a high tax bracket can place income-producing assets—like rental property, stocks, or bonds—into a S corporation in exchange for voting stock issued to themselves. Parents can also issue up to $24,000 of nonvoting shares to their children. The benefit here is this transfer will be free
from gift tax and will remove the value of the nonvoting stock from the parent’s taxable estate. In addition, the transfer shifts dividend income to children (who should be in lower tax brackets). For this tax savings to be effective the children must be at least 24 years old or, if the children are at least 18 years old and full time students they must be supported by at least half of their own earned income.

This asset and income shifting technique is more flexible than an irrevocable trust because the parents or shareholders of the family-owned S corporation retain full control of the business so long as they own all of the voting shares. However, one must be careful because if the children are under the age of 18 or if they are full-time students under age 24 and less than half of their support comes from earned income, then any income from the S corporation stock over $1,700 will be taxed at their parent’ top marginal rate.

The S corporation is not the best fit in all situations, but a qualified attorney can help you to determine if this tax saving devise is the right choice for your family-owned business.

This Article appeared in the June 2009 and the June 2010 issue of The Valley Business Journal

For more information on business and estate planning matters, please contact us at (619) 238-1712 or see our practice areas for a detailed attorney list.

San Diego [1]
Business [2]
Estate Planning & Administration [3]

Back to Articles [4]

Source URL: https://www.neildymott.com/s-corp-right-your-family-owned-business

Links: