Module 1.6: S Corporations

Before the creation of S corporations, entrepreneurs could form a corporation, partnership, or sole proprietorship, and that was it. None of these choices was the best for small businesses or family owned businesses, though.

So, in 1946 the Department of Treasury suggested another option with one layer of taxes and liability protection. At the same time, both political parties were concerned about the consolidation of power amongst the corporations. As a response to this political climate, President Eisenhower suggested the creation of a small business corporation, and in 1958, Congress created subchapter S of the tax code. This was a huge step in the encouragement of small and family business creation in the US.

By 2003, S corps were the most common form of business structure in the US, with nearly 62% of businesses filing tax form 1120S. However, the limitations of S corporations have never been updated to address the current economic environment, *and* with the creation of LLCs, entrepreneurs are now moving to the advantages and flexibility they provide.

S corporations are special types of corporations designed to avoid the double taxation C corporations often face. S corporations have the advantage that profits (and losses) can "pass-through" to the shareholder's personal tax returns. Because of this structure, only the shareholders are taxed and not the business itself, on profits.

S corporations are small business corporations that meet the requirements of Subchapter S of the Internal Revenue code. An S corporation is really a hybrid. You first create a C corporation with the Secretary of State's office in your state. Then, you fill out the S Election form (IRS Form 2553) and send it to the IRS. The election should be signed by the same person authorized to sign the corporation's tax return and **all** shareholders on the date of the election must also sign and consent to it. You then fax it to the IRS via the number provided in the instructions and remember to keep the confirmation page - or if you decide to mail it, remember to always send anything to the IRS by certified or registered U.S. Mail receipt.

The IRS should send you a notification regarding the acceptance or denial of the S election within two months of the filing date.

This election combines the liability advantages of a C corporation with many of the federal income tax characteristics of a partnership. Essentially, the taxes on profit or loss are paid at the shareholder level instead of at the corporate level. This can produce significant tax savings, because as you will see in Module 3.7, part of the profits are only taxed as investment income.

Next to sole proprietorships, S corporations are being increasingly popular for newly incorporated businesses, as well as existing C corporations that meet the requirements. In fact, statistics show in the past few years, there have been a greater number of conversions from C corporations to S corporations than new incorporations immediately electing the S-corporation election.

Large and public corporations usually can't choose the S election because there has to be no more than 100 shareholders or no more than one class of stock.

Small Business Requirements

The following requirements must be met in order to qualify as a small business eligible for the S election:

- Be a domestic corporation, or a domestic entity eligible to be treated as a corporation, that timely files Form 2553.
- Have no more than 100 shareholders.
- Only have shareholders that are individuals, estates, 401(a) or 501(c)(3) exempt organizations, or certain trusts.
- Have no nonresident alien shareholders.
- Have only one class of stock.
- Use an acceptable tax year.
- Have the consent of all shareholders to the election.

In addition, certain types of corporations are ineligible, even if they meet all of the above requirements. The following are ineligible to elect S corporation status:

- A bank that uses the reserve method of accounting for bad debts.
- An insurance company subject to tax under subchapter L of the Internal Revenue Code.
- A corporation that has elected to be treated as a possessions corporation under Section 936.
- A domestic international sales corporation (DISC) or a former DISC.

I doubt if any of you will be creating those types of businesses, but I mention them here to give you a complete picture.   The three main ongoing requirements are having less than 100 shareholders, one class of stock, and not allowing nonresident aliens to purchase stock.

A corporation is eligible to be taxed as an S-corporation only if it satisfies these small business requirements *each* fiscal year. Therefore, if you have a rapidly growing business, you must make sure that you *continue* to qualify for eligibility, or it will fall back into a regular C corporation status with some unexpected tax results. But, should this happen, not all is lost. You can ask the IRS for a waiver and time to fix the problem to bring your business back into compliance -

however, it is at their discretion to allow the waiver. And they usually will if was an honest mistake.

Existing Businesses vs New Businesses

You should note that the process for electing S corporation status is different between existing businesses (any structure other than an S corporation) and brand new business entities. For example, a brand new business has two months and fifteen days (usually 75 days) to elect to be an S corporation if they want be considered an S corporation from the first day they go into business. So, if you start your business on March 1st, your have until May 15th to file the Form 2553. If accepted, your S corporation will also count as started on March 1st.

For existing businesses, the S corporation election paperwork should to filed within two months and fifteen days of the beginning of the entity's tax year to ensure that the entire tax year is governed by the new S corporation status. For example, you have a C corporation and use the calendar tax year ending on December 31st. You decide that the next year you want to take advantage of the tax savings of an S corporation. You would have until March 15th to file the Form 2553 and state you wanted to begin the election back on January 1st. If you file the 2553 after March 15th, you would begin your S election in the following year on January 1st.

While rarely used, other legal entities like sole proprietorships, partnerships, and LLCs can choose to be taxed as an S corporation. The process for this would be to file Form 8832, Entity Classification Election with the IRS, which is an election to be treated as a corporation. And then file Form 2553, to elect to be treated as an S corporation. This course of action is not recommended unless there are sound reasons for it and it is recommended that you consult a tax advisor first. We'll also discuss this option in more detail in module 3.9.

An S election may be cancelled and the corporate status returned to a regular corporation, but if this is done, there is a five year waiting period until you apply again for the S-corporation status. I also want to warn that if your C corporation has a Net Operating Loss being carried over year-to-year, you can't move it to the S-corporation. It just sits there in limbo until you cancel the election and become a C corporation again.

BTW, you will find a link to IRS Form 2253 in the section under this video. (https://www.irs.gov/pub/irs-pdf/f2553.pdf)

Next, let's take a brief look at how states handle S corporations. Some states do not recognize the federal S corporation election and may tax the S corporation as a C corporation or impose additional requirements. However, most states recognize S corporations as the federal government does and tax shareholders as such, but because many S corporations do business in multiple states, paying close attention to how S corporations are taxed each state the business conducts operations in is imperative.

For instance, some states tax S corporations on profits over a specified amount like Massachusetts, others recognize S corporations as C corporations with the same tax burdens, and some states tax S corporation's profits *and* the shareholders share of the profits like New Jersey and New York.

Some states that recognize an S corporation as a pass-through entity may subject a tax on resident and *non*resident S corporation shareholders. This means if you are a shareholder of an S corporation that doesn't even do business in your state, your state can still tax you on the profits.

Also a state (like California) where the business in *not* incorporated may be able to tax an S corporation and/or its shareholders on all or part of the S corporations income if:

- the S corporation has a sufficient connection to be considered as doing business in the state,
- the S corporation maintains a place of business within the state and/or
- the S corporation derives income generated by property owned by the S corporation with the state.

And a state that taxes nonresident shareholders may require the S corporation to withhold and pay estimated taxes on behalf of those shareholders.

As you can see, there are a lot of variable to consider when deciding which legal format you wish to operate as. At the beginning of this course, I mentioned that you need to have an understanding of all three pillars of building a solid foundation under your business, and I hope that at this point you are beginning to see how legal structures, tax structures, and the paperwork involved are all intertwined. That said, there is still a lot more to consider. Let's move on.

While all businesses can hire employees, there are some special considerations when it comes to the shareholder-owners of an S corporation. In most S corporations, the work is done by the owners and maybe a few employees. Like C corporations, you must have all employees fill out Form I-9, *Employment Eligibility and Identity Verification* stating they are in this country legally, Form W-4, *Employee's Withholding Allowance Certificate* and then withhold income from each employee's salary based on the exemptions claimed on the W-4.

Just like if you purchased stock in a company like IBM and received dividends, the profits that flow down to the stockholder from an S-corporation are not subject to self-employment tax as it is considered investment income. Because of this, many owners do not pay themselves a salary in an attempt to avoid payroll taxes or from simple ignorance of the law.

However, the IRS does not allow this. If the corporation's tax return is audited, the IRS may reclassify some of the profits and hand the corporation (and thus the shareholders) a bill for the payroll taxes that should have been paid, along with penalties and interest.

The Internal Revenue Service examines C corporations to see if the shareholder-employees are paying themselves too much and examines S corporations to see if the shareholder-employees are paying themselves too little. Therefore, when figuring the S corporation's budget, it is best to determine what you would pay an employee to do your job in the current job market - and make that your salary.

Now, the salary you pay yourself doesn't have to be that of a CEO, but should be at least be as much as you would pay a new employee doing your job. The U.S. Bureau of Labor Statistics list the average wages per occupation on their website to give you an idea of what you should be paying yourself. I have put a link to that page in the section under the video.

Paying yourself a salary provides some withholding to pay your taxes for the year, reducing the amount of estimated taxes you have to send into the IRS quarterly. It also adds money to your social security/medicare accounts for when you retire.

But most importantly, it prevents you from being charged by the IRS with evasion of payroll taxes. We will discuss this in more detail in module 3.

If you are planning to do business internationally, then S corporations are recognized because they are essentially a corporation, and their S status is merely a tax election. Unfortunately, S corporations are prohibited from having foreign or non-resident shareholders. This becomes important if you wish to bring on additional investors. So how do we figure out if a person living here can be an S corporation shareholder?

A non-resident alien is neither a citizen of the United States nor a resident alien and can’t be a shareholder of an S corporation. A resident alien or a foreigner with a green card is allowed to be. Most people don’t really know the difference, so here is a brief description.

Under the green card test, the alien has to be a lawful permanent resident with a green card. If you have a green card, the time of your presence in this country does not matter; you qualify as an S corporation shareholder.   However, if you are in the U.S. on a non-immigrant visa, then you can only be considered a resident alien if you pass the “substantial presence test” and thus qualify as an S corporation shareholder.

A resident alien has lived in this country 183 days or more during the year. If you haven’t lived in the U.S. for 183 day in the current year, they also have a complex formula where you can get to 183 by adding the number of days in the current year (31minimum), plus 1/3 of the days in the preceding year, plus 1/6 of the days in the second preceding year you lived here.   (While you will probably never have to worry about this, it does show how complex tax returns can get for people that just moved to this county.)

Further, because tax law does not permit corporations or partnerships from being shareholders in an S corporation, this would disallow foreign corporations or partnerships from being shareholders. However, individuals, certain types of trusts, and estates may be shareholders as long as they satisfy the non-resident rules.

The concern here is that if a non-resident alien *or* an alien who lost their resident status was to become a shareholder of an S corporation, the S corporation could lose their status as an S corporation. There are many business owners and economists that are trying to get this limitation changed, since foreign investors are now already required to pay U.S. taxes the same as citizens. Unfortunately, congress is not concerned about such things at the moment. I just wanted to spend a few minutes to explain this limitation, so that you have all the information you need in making your decisions.

Finally, you need to create an *S Corporation Shareholder Agreement*. Since all corporations start at the state level as a C corporation, you will begin by creating an Articles of Incorporation document. Because of the limitations in the number of members and single class of stock, S corporations are usually small, privately owned entities and therefore you may want to consider adding some additional previsions to it.

For instance, since there is only one class of stock, you may want to put in a caveat that the S corporation may have first rights to purchase back stock upon the death, divorce, disability, or termination of employment to keep control of who owns the corporation.

You will find a sample Articles of Incorporation link in the download section. If you would like a fill in the blank online process to create your Articles of Incorporation, there are a lot of sites out there that will help you. A link to one of them (https://formswift.com/articles-of-incorporation) is also listed in the section below and in the transcript.

Let's review the pros and cons of the S corporation status:

The Pros:

- Liability protection similar to that of C corporations.
- No double taxation of profits.
- Ownership is easily transferred through the sale of stock.
- Separate entity from stockholders.
- Self-employment tax is not assessed on the entire profit of the business.
- Losses can offset shareholders' other taxable income.

The Cons:

- Complex and expensive to create and maintain.
- Requires a separate tax return.
- Requires regular board of directors' meetings and minutes.
- Requires tracking of basis for stockholders.
- Ownership is limited to specific types of entities.
- Deductibility of fringe benefits for owner-employees is limited.
- Must pay employee/shareholder(s) a reasonable wage/salary
- Non-compliance with regulations may result in termination of S corp statusIf terminated by the IRS, there is a five-year waiting period for reinstatement, and there will be back taxes to pay (three years). The terminated S corporation will be treated as a C corporation.
- Shareholders will pay taxes on their share of income, whether or not distributed.
- One class of stock
- Limited to 100 shareholders

I'd like to add one additional point.

There are many ways to create a corporation and they are different in each state. However, it is generally done by the majority stockholder(s) or by someone hired to create the corporation for them. There are many firms that specialize in creating corporations for people. Unfortunately, they sometimes make mistakes and unless you know the basics that have been discussed in this course, you may not catch it until tax filing time.

The biggest mistake that seems to be made is for the firm hired (or the stockholder) to file for the corporation at the state level correctly, but forget to file the Form 2553 at the IRS to obtain the S election in a timely manner. If this happens, a process is in place to apply for an exception. The IRS usually grants the exception if a reasonable excuse is given to not filing on time. A tax advisor specializing in corporations should be able to help file for this exception properly.