



CORPORATION OR C-CORP FORMATION

A subchapter "S" Corporation, also called an S Corporation, is a corporation that once incorporated, elects a special tax status. The Subchapter S tax election enables the shareholder to pass through earnings and profits directly to their personal tax return. If the corporation has a profit, the shareholder, if working for the company, must pay themselves wages that meet the standards of "reasonable compensation."

An S Corporation begins its existence as a "C-Corporation" as a general, for-profit corporation upon filing the Articles of Incorporation with the appropriate STATE office. However, after the corporation has been formed, it may elect "S Corporation Status" by submitting IRS form 2553 to the Internal Revenue Service (in some cases a state filing is required as well).

Once this filing is complete, the corporation is taxed like a partnership or sole proprietorship rather than as a separate entity. Thus, the income is "passed-through" to the shareholders for purposes of computing tax liability. Therefore, a shareholder's individual tax returns will report the income or loss generated by an S corporation.

After a corporation has been formed, it may elect "S-Corporation Status" by adopting an appropriate resolution and completing and submitting a form to the Internal Revenue Service (some states require their own version). Once this filing is complete, the corporation is taxed like a partnership or sole proprietorship rather than a corporation. Thus, the income is "passed-through" to the shareholders for purposes of computing tax returns.

Most new small corporations elect S-Corporation Status (90%+) so profits and losses can be added to the shareholders' personal tax returns without having to pay taxes on profits once, then again when they are given back to the shareholders as income (dividends). This is known as "double taxation" and is the reason why S-Corporations were created. An S-Corporation can also revert back to regular Corporation status fairly easily.

There are some limitations on S-Corporations: they cannot deduct some expenses like health insurance, travel, entertainment, etc. that normal corporations can. Also, they are restricted to 100 shareholders or fewer and those shareholders must be U.S. Citizens. Finally, S-Corporations may not own or be owned by other business entities.

PROS

- Prestige of the corporation without the double taxation. Ideal for "1 person corporations".
- Have less risk from government audits as a corporation (as opposed to sole proprietor or LLC),
- Limited personal liability for business debts,
- Owners can use corporate losses to offset income from other states,
- Save on employment taxes by taking distributions instead of salary, and
- There is no double taxation threat because the corporation is not a separate taxable entity.

CONS

- More expensive to setup than a DBA;
- more paperwork and formality required than an LLC (holding Shareholder/Board meetings, keeping minutes and resolutions).

Though taxed in a similar manner to LLC's, still requires the corporate formalities of a regular corporation (holding Board meetings, keeping minutes and resolutions).

There are restrictions on who can be owners (called "shareholders") of an S corporation.

- Can have no more than 75 Shareholders,
- None of the shareholders can be nonresident aliens.,
- Shareholders cannot be other corporations or LLCs. and
- An S corp is operated in the same way as a traditional C corp.
- An S corp must follow the same formalities and record keeping procedures.
- The directors or officers of an S corp manage the company, and
- An S corp has no flexibility in how profits are split up amongst its owners.
- The profits must be distributed according to the ratio of stock ownership, even if the owners may otherwise feel it is more equitable to distribute the profits differently.

Qualifying for S Corporation Status.

A corporation must timely file IRS Form 2553 with the IRS. This election must be made by March 15 of the current year if the corporation is a calendar-year taxpayer in order for the election to take effect for the current tax year.

However, a "New" corporation may make the filing at anytime during its tax year so long as the filing is made no later than 75 days after the corporation has began conducting business as a corporation, acquired assets, or has issued stock to shareholders (whichever is earlier).



To qualify for S corporation status, the corporation must:

- Be filed in one of the 50 United States.
- Maintain only one class of stock.
- Maintain a maximum of 75 shareholders.
- Be comprised SOLELY of shareholders who are individuals, estates or certain qualified trusts, who consent in writing to the S corporation election.
- NOT have a shareholder who is a non-resident alien

Losing S-Corporation Status.

Failure to observe ANY of the above requirements could revoke S-Corporation status at any time. An S-Corporation that loses its status as such may not re-elect S-Corporation status for a minimum of five years.

Corporate Formalities.

An S-Corporation follows the same state formalities as does a C-corporation (i.e. filing Articles of Incorporation and paying state fees).

IRS Filings.

The S-Corporation must complete and file IRS Form 1120s to report its annual income to the IRS each year.

General Shareholder Requirements.

ALL shareholders of the corporation must be U.S. Citizens or have U.S. Residency Status. If, for any reason, shares are somehow sold or transferred (even if by will, divorce, or other means) to a shareholder who is a foreign national, the corporation will lose its S-Corporation status and be treated as a C-Corporation.

Who Should Elect S-Corporation Status?

Owners who want the limited liability of a corporation and the "pass-through" tax-treatment of a partnership will often make the S-Corporation election. In most cases, corporations that would benefit from S-Corporation status are those who plan on distributing the majority of earnings to its shareholders in the year those earnings are realized.

Corporations who plan on retaining earnings for future investments in future tax years often choose the C-Corporation because, under the S-Corporation, earnings will be taxed as if they were distributed to shareholders regardless of whether a distribution actually occurred or whether the corporation retained the earnings for future.