

S Corporation Facts

S corporations limit owners' liability and offer the tax structure of a partnership.

Many entrepreneurs have two goals when choosing a structure for their business: protecting their personal assets from business claims (limited liability) and having business profits taxed on their individual tax returns. Not long ago, an S corporation was the only choice for these business owners. In recent years, however, S corporations have been largely replaced by limited liability companies (LLCs). Still, some businesses can benefit by organizing as S corporations.

What Is an S Corporation?

An S corporation is a regular corporation that has elected "S corporation" tax status. Forming an S corporation lets you enjoy the limited liability of a corporate shareholder but pay income taxes as if you were a sole proprietor or a partner.

In a regular corporation (also known as a C corporation), the company itself is taxed on business profits. The owners pay individual income tax only on money they receive from the corporation as salary, bonuses, or dividends.

By contrast, in an S corporation, all business profits "pass through" to the owners, who report them on their personal tax returns (as in sole proprietorships, partnerships, and LLCs). The S corporation itself does not pay any income tax, although an S corporation with more than one owner must file an informational tax return, like a partnership or LLC, to report each shareholder's portion of the corporate income.

Most states follow the federal pattern when taxing S corporations: They don't impose a corporate tax, choosing instead to tax the business's profits on the shareholders' personal tax returns. About half a dozen states, however, tax an S corporation like a regular corporation. The tax division of your state treasury department can tell you how S corporations are taxed in your state.

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Should You Elect S Corporation Status?

Operating as an S corporation may be wise for several reasons:

- Forming an S corporation generally allows you to pass business losses through to your personal income tax return, where you can use it to offset any income that you (and your spouse, if you're married) have from other sources.
- When you sell your S corporation, your taxable gain on the sale of the business can be less than it would have been had you operated the business as a regular corporation.
- S corporation shareholders are not subject to self-employment taxes (active LLC owners are). These taxes, which add up to more than 15% of your income, are used to pay your Social Security and Medicare taxes.

Aside from the benefits, S corporations impose strict requirements. Here are the main rules:

- Each S corporation shareholder must be a U.S. citizen or resident.
- S corporations may not have more than 100 shareholders.
- S corporation profits and losses may be allocated only in proportion to each shareholder's interest in the business.
- An S corporation shareholder may not deduct corporate losses that exceed his or her "basis" in corporate stock -- which equals the amount of the shareholder's investment in the company plus or minus a few adjustments.
- S corporations may not deduct the cost of fringe benefits provided to employee-shareholders who own more than 2% of the corporation.

Fortunately, a decision to elect to be an S corporation isn't permanent. If your business later becomes more profitable and you find there are tax advantages to being a regular corporation, you can drop your S corporation status after a certain amount of time.

How to Elect S Corporation Status

To create an S corporation, you must first create a regular corporation by filing articles of incorporation with your secretary of state's office or your state's corporations division. Then, to be treated as an S corporation, all shareholders must sign and file IRS Form 2553.

S Corporation Alternatives

You can get the benefits of limited liability and pass-through taxation by creating a limited liability company (LLC). Because an LLC offers its owners the significant advantage of greater flexibility in allocating profits and losses, and because LLCs aren't subject to the many restrictions of S corporations, forming an LLC is often the better choice.