

S-CORPORATIONS

DEFINITION

An S-corporation is a corporation that makes a valid election to be taxed under the Subchapter S provision of Chapter One of the Internal Revenue Code (IRC). In general, S-Corporations themselves are not subject to federal income taxes. Instead, the corporation's income or losses are divided among and passed through to its shareholders. The shareholders must then report the income or loss on their respective individual income tax returns. This allows S-Corporations to avoid double taxation on its income.

HOW THEY WORK

QUALIFICATION

To qualify for S-Corporation status, a corporation must satisfy the following requirements:

- Be a domestic corporation,
- Have only allowable shareholders including individuals, certain trust, and estates and may not include partnerships, corporations, or non-resident alien shareholders,
- Have no more than 100 shareholders,
- Have one class of stock,
- Not be an ineligible corporation (i.e. certain financial institutions, insurance companies, and domestic international sales corporations).

ELECTION

A corporation must elect to be taxed as an S-Corporation by filing form 2553 with the Internal Revenue Service. This form must be filed:

- No more than two months and 15 days after the beginning of the tax year the election is to take effect, or,
- At any time during the tax year preceding the tax year it is to take effect.

Once the election is made, it stays in effect until it is terminated or revoked.

TAXATION

An S-corporation does not pay federal income tax. Under California law, the S-Corporation is subject to a 1.5 percent tax on its net income and is a conduit similar to a partnership. The items of income, deductions, and credits "pass-through" from the S-Corporation to each shareholder through the Schedule K-1. Each shareholder is then responsible for paying taxes on their share of the S-Corporation's items of income, deductions, and credits. The S-Corporation tax status allows a company

to avoid double taxation, a tax on corporate income and a second tax on amounts distributed to shareholders.

SALARY VS. DISTRIBUTIONS

As previously mentioned, S-Corporations pass-through all profits and losses to the shareholders. This dividend income is then taxed at ordinary income rates. However, distributions from an S-Corporation are not subject to FICA and Medicare taxes, which could mean a potential savings of up to 15.3%. This means that a shareholder who is also an employee of an S-Corporation may be tempted to pay themselves less salary and more profits. However, the IRS prevents excessive abuse of this by requiring an S-Corporation to pay all employees a “reasonable salary.” There are no specific guidelines for determining reasonable compensation but factors such as training, experience, duties, responsibilities, and comparable industry salaries must be taken into account when determining an appropriate amount.

DEBTS AND LIABILITIES

As a corporation, S-Corporation owners are protected from personal liability for business debts and claims. This limited liability means that if the business owes money or is sued, only the assets of the business itself are at risk. Creditors usually cannot reach the personal assets of the corporation’s members. However, this liability protection is not applicable if the S-Corporation members act illegally or unethically.

CONTINUITY

An S-Corporation designation also allows a business to have an independent existence, separate from its shareholders. If a shareholder leaves the company, or sells his or her shares, the S-Corporation can continue doing business relatively undisturbed.

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