S Corp Advantages & Disadvantages

Summary

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Whether you are just starting your business or have been operating as a sole proprietorship or general partnership, you may wonder about the advantages of incorporating your business as an S corporation. Many business owners assume it will be too costly or time-consuming — but neither is the case.

What is an S corporation (S Corp)?

A corporation is taxed for federal income tax purposes in one of two ways – as a “C corporation” or an “S corporation.”

An S corporation is a corporation that is treated, for federal tax purposes, as a pass-through entity through an election made with the Internal Revenue Service (IRS). Electing “S Corp” status could lead to significant tax benefits.

A corporation is created by filing Articles of Incorporation with the Secretary of State or a similar government body. There is no requirement to notify your state of incorporation that your corporation will be an S corporation. This is a tax matter handled by the IRS.
The difference between a C corporation and an S corporation is how they are taxed under income tax laws. The state corporation laws make no distinction. An S corporation issues stock and is governed as a corporation, with directors, officers, and shareholders who function like their C corporation counterparts. The owners (the shareholders) have the same protection from liability as shareholders of a C corporation. An S corporation shareholder’s asset, such as personal bank accounts, cannot be seized to satisfy business liabilities.

However, like a sole proprietorship or a partnership, an S corporation passes through most of its income, losses, and deductions to the shareholders. Unlike a C corporation, there is no "double taxation," once at the corporate level and again at the individual shareholder level. Each shareholder is subject to their own individual tax rate on the income (or losses) passed through to them.

Why is it called an S corporation?

The S corporation derives its name from Subchapter S of the Internal Revenue Code, which provides corporations a "tax election" option — a choice on how they want to be taxed. Under Subchapter S, a company must pass all its profits to its shareholders directly. (The C corporation gets its name from Subchapter C of the IRC – which is part of the tax law under which corporations will be taxed unless they make the S corporation election.)

What are the requirements for an S corporation?

To qualify for S corporation status, your corporation must meet the following requirements:

- Be a domestic corporation.
- Have only allowable shareholders.
- Have no more than 100 shareholders.
- Have only one class of stock.
- Not be an ineligible corporation such as certain financial institutions, insurance companies, and domestic international sales corporations.

To become an S corporation, your corporation must submit Form 2553 Election by a Small Business Corporation signed by all the shareholders.

S corporation advantages: tax benefits and more

The advantages of an S corporation often outweigh any perceived disadvantages. The S corporation structure can be especially beneficial when transferring ownership or discontinuing the business. These advantages are typically unavailable to sole proprietorships and general partnerships.

S corporation advantages include:

- Protected assets. An S corporation protects the personal assets of its shareholders. Absent an express personal guarantee, a shareholder is not personally responsible for the business's debts and liabilities. Creditors cannot pursue the shareholders' assets (house, bank accounts, etc.) to pay business debts. In a sole proprietorship or general partnership, owners and the business are legally considered the same — leaving personal assets vulnerable.

- Pass-through taxation. An S corporation does not pay federal taxes at the corporate level. (Most — but not all — states follow the federal rules. View our state guides' Ongoing Corporation Requirements page to see if your state recognizes the federal S corporation election.) Any business income or loss is "passed through" to shareholders who report it on their personal income tax returns. This means that business losses can offset other income on the shareholders' tax returns. This can be extremely helpful in the startup phase of a new business. (A corporation that does not elect S corporation status and accumulates passive income is at risk of being classified as a personal holding company.)

- Tax-favorable characterization of income. S corporation shareholders can be business employees and draw salaries as employees. They can also receive dividends from the corporation and other tax-free distributions to the extent of their investment in the corporation. A reasonable characterization of distributions as salary or dividends can help the owner-operator reduce self-employment tax liability while generating business expenses and wages-paid deductions for the corporation.

- Straightforward transfer of ownership. Interests in an S corporation can be freely transferred without triggering adverse tax consequences. WHEN AN OWNERSHIP INTEREST IS TRANSFERRED, the S corporation does not need to adjust to property basis or comply with complicated accounting rules.

- Cash method of accounting. C Corporations must use the accrual method of accounting unless they are considered "small corporations" and meet the IRS' gross receipts test. S corporations, however, usually don't have to use the accrual method unless they have inventory.

- Heightened credibility. Operating as an S corporation rather than a sole proprietorship or partnership may help a new business establish credibility with potential customers, employees, vendors, and partners because they see the owners have formally committed to their business.

S corporation disadvantages

An S corporation may have some potential disadvantages, including:

- Formation and ongoing expenses. To operate as an S corporation, you must first incorporate your business by filing Articles of Incorporation with your desired state of incorporation, obtaining a registered agent for your company, and paying the appropriate fees. Many states also impose ongoing fees, such as annual reports and franchise tax fees. Although these fees usually are not expensive and can be deducted as a cost of doing business, they are expenses that a sole proprietor or general partnership will not incur.

- Tax qualification obligations. Mistakes regarding the various election, consent, notification, stock ownership, and filing requirements can accidentally result in the termination of S corporation status and result in the corporation being a taxpaying entity under Subchapter C. Although this is relatively rare and usually can be remedied easily, it is still an issue that is not a factor with other pass-through tax classifications.

- Calendar year. An S corporation must adopt a calendar year as its tax year unless it can establish a business purpose for having a fiscal year.

- Stock ownership restrictions. An S corporation can have only one class of stock, although it can have both voting and non-voting shares. Therefore, there can't be different classes of investors entitled to different dividends or distribution rights. Also, there cannot be more than 100 shareholders. Foreign ownership is prohibited, as is ownership by certain trusts and other entities.

- Closer IRS scrutiny. Because amounts distributed to a shareholder can be dividends or salary, the IRS scrutinizes payments to ensure the characterization conforms to reality. As a result, wages may be recharacterized as dividends, costing the corporation a deduction for compensation paid. Conversely, dividends may be recharacterized as wages, which subjects the corporation to employment tax liability.

- Less flexibility in allocating income and loss. Because of the one-class-of-stock restriction, an S corporation cannot allocate losses or income to specific shareholders. Allocation of income and loss is governed by stock ownership, unlike partnerships or LLCs taxed as partnerships where the allocation can be set in the partnership agreement or operating agreement. (Note: C corporation shareholders ordinarily can't deduct any losses unless their stock becomes worthless or is sold at a loss.)

- Taxable fringe benefits. Most fringe benefits the corporation provides are taxable as compensation to employee shareholders who own more than 2 percent of the corporation.

What is the difference between an S Corp and a C Corp?

The difference between an S corporation and a C corporation is in how they are taxed under the Internal Revenue Code. A C corporation is the standard (or default) corporation under IRS rules. It is a separate taxable entity. A C corporation files its income tax return and pays taxes on its income at the federal corporate income tax rate. All corporations are taxed as C corporations unless the corporation makes an election to be taxed as an S corporation.

An S corporation is a corporation that has elected a special tax status with the IRS. An S corporation is not a separate taxable entity. It files an information return but not an income tax return. The corporation's income, losses, and other tax items pass through to its shareholders, who pay their share of its profits on their tax return at the personal income tax rate.
To learn more about taxing a corporation's income, read Compare S corporation vs. C corporation.

Do you know about LLCs and S Corp elections?

To take advantage of the structural benefits of an LLC combined with the taxation benefits of an S Corp, you can establish your business entity as an LLC and then make the election to have it be treated as an S corporation by the IRS for income tax purposes. However, regardless of how an LLC is taxed (and it can be taxed in the same manner as an S corporation, C corporation, sole proprietorship, or general partnership), it is still an LLC. Its tax classification does not affect its entity status – it's still an LLC. Read more about LLCs electing S Corp tax status.

How to form an S corporation

To form an S Corp, you must first form a corporation by preparing and filing Articles of Incorporation or a Certificate of Incorporation with the proper state authorities. You must also pay filing fees and any applicable initial franchise taxes or other fees. The type and amount of information required in the incorporation documents varies by state.

After filing your Articles of Incorporation, you must file Form 2553 with the IRS to elect S corporation status for your company.

Additionally, your S corporation must hold an organizational meeting (initial meeting of directors) where you adopt bylaws and undertake other initial corporate actions (such as appointing officers and approving a resolution to open a business bank account). You should distribute stock certificates to shareholders and record these transactions in the company's stock transfer ledger. The actions of the organizational meeting should be documented and kept along with the Articles of Incorporation and bylaws in a corporate record book.

For specific questions on which business structure and tax classification are best for your situation, it is best to consult an attorney or accountant.

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