

What Is An S Corporation Election

By Liz Altman

An S Corporation (S Corp) is an option for a small business to be classed as a corporation while avoiding double taxation imposed on C corporations. Any income and losses are passed through to shareholders to report on their tax returns. It can be a tool to gain corporate status in a more manageable way for a smaller business.

Benefits

Like an LLC, an S Corp offers limited liability protection to shareholders and employees along with pass-through taxation. One reason to consider filing for S Corp status is that it could mean paying less in taxes. Upon formation, an LLC is automatically taxed as a sole proprietorship, including a self-employment tax for Social Security and Medicare. In an S Corp, shareholders are considered employees and get paid a salary, with the business paying employment taxes that could be deducted as a business expense from the company's taxable income. Any leftover profits are distributed to shareholders as dividends with a lower tax rate than regular income.

Another advantage of an S Corp over an LLC is that stock can be transferred freely, as long as the transfer complies with IRS guidelines and the shareholder agreement. An LLC often requires other members' approval for transfers of membership interest.

Drawbacks

Unlike an LLC, which has few legal limitations on formation and operating practices, S corps have more restrictions:

LLC	S Corporation
No limits on the number of members.	No more than 100 shareholders.
Non-U.S. citizens or residents can be members.	Shareholders must be legal residents of the U.S.
No restrictions on members: trusts, partnerships, and other LLCs can be members.	Cannot be owned by corporations, LLCs, partnerships, or many types of trusts.
No restrictions on membership share distribution.	Cannot issue more than one type of stock, e.g. giving shareholders preference of distribution over others.

Another potential drawback of an S Corp is the cost, which can vary depending on the state of incorporation and the nature of the business, like an LLC. Possible fees include:

- Fees for the articles of incorporation (\$100-\$250, depending on the state).
- Attorney fees to process the legal documents.
- Annual reporting fees in the state (\$500-800 per year, not required by all states).
- Accounting fees for tax preparation and financial reporting; and
- Insurance payments

Filing for S Corp Status

S corps have a more involved formation process than LLCs. Like an LLC, an S Corp must file the required paperwork in the state of incorporation, apply for any necessary business licenses, and obtain an Employer Identification Number (EIN). Also, beginning January 1, 2024, many business entities must report Beneficial Ownership Information (BOI) under the Corporate Transparency Act. (See the previous blog on CTA)

Some jurisdictions, like New York City, Louisiana, and Texas, do not recognize federal S Corp elections and generally tax S Corps like other corporations. Other states require specific separate election forms. Many state and local jurisdictions have unique guidelines in addition to the federal rules, so it is a good idea to carefully review business regulations in the planned area of incorporation.

To obtain S Corp status, the company must also issue stock certificates to initial shareholders and file IRS Form 2553 signed by all shareholders. Since all corporations are automatically classed as C Corps on initial formation, with double taxation requirements, Form 2553 must be filed within 75 days to receive S Corp tax benefits.

A business that meets the definition of an "ineligible corporation", such as certain financial institutions, insurance companies, and domestic international sales corporations, cannot be granted S Corp status.

Creating an S Corporation, like any business entity, is a complex, time-intensive process with much paperwork. It is therefore advisable to consult financial and legal professionals to provide guidance and ensure the required tasks are completed correctly. Call the attorneys at Altman & Associates at [301-468-3220](tel:301-468-3220) or contact us through altmanassociates.net.

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