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Business Structures and S Corporation

Of all the choices you make when starting a business, one of the most important is the type of legal organization you select for your company. While state law controls the formation of your business, federal tax law controls how your business is taxed.

Sole Proprietorship and Partnership

Sole proprietorship and partnership are the most common form of business organization. It is easy to form, generally requires a simple registration through County Clerk. And, net business income or loss is combined with sole proprietor or each partner's other income and deductions and taxed at individual rates on personal tax return.

However, sole proprietorship and partnership, have unlimited liability and are legally responsible for all debts against the business. Their business and personal assets are at risk.

Corporation

A corporate structure is more complex than other business structures. It requires complying with more regulations and tax requirements. It may require more tax preparation services than the sole proprietorship or the partnership.

Corporations (regular corporations are known as C Corporations) are formed under the laws of each state and are subject to corporate income tax at the federal and generally at the state level as well. In addition, any earnings distributed to shareholders in the form of dividends are taxed at individual tax rates on their personal tax returns. Thus, it is also known as, double taxation.

However, shareholders have limited liability and are generally not personally liable for the debts of the corporation.

Subchapter S Corporation

The Subchapter S Corporation is a variation of the C Corporation. An S corporation has the same corporate structure as a C corporation. Shareholders have limited liability and are generally not personally liable for the debts of the corporation. However, unlike C corporations, S corporation allows income or losses to be passed through schedule K-1 to individual tax returns, similar to a partnership.

Generally, an S corporation is exempted from federal income tax other than tax on certain capital gains and passive income. It is treated in the same way as a partnership, in that generally taxes are not paid at the corporate level. In other words, S corporations are not subject to double taxation.

The above paragraph provides a glance on the benefit of the S corporations of not being taxed twice. Yet, not every corporation is eligible to be treated as an S Corporation. To be eligible, the following requirements must be met:

1. Must be a domestic corporation, which is registered at the federal level or state level of the United Stated.
2. Must have only one class of stock (disregarding differences in voting rights). Generally, a corporation is treated as having only one class of stock if all outstanding shares of the corporation's stock confer identical rights to distribution and liquidation proceeds. See Regulations section 1.1361-1(l) for details.
3. Must not have more than 100 shareholders (spouses are automatically treated as a single shareholder).
4. Shareholders must be physical entities (a person). Therefore, corporate shareholders and partnerships are to be excluded.
5. Shareholders must be U.S. citizens or permanent residents. Nonresident aliens cannot be the shareholders.
6. It is not one of the following ineligible corporations.
    a. A bank or thrift institution that uses the reserve method of accounting for bad debts under section 585.
    b. An insurance company subject to tax under subchapter L of the Code.
    c. A corporation that has elected to be treated as a possessions corporation under section 936.
    d. A domestic international sales corporation (DISC) or former DISC.

If a corporation meets the foregoing requirements and wishes to be taxed under Subchapter S, its shareholders may file Form 2553: "Election by a Small Business Corporation" with the IRS.

1. Form 2553 must be signed by all of the corporation's shareholders.
2. An S corporation generally adopt calendar year (begins on January 1 and ends on December 31) as its tax year. However, an option to select fiscal year is available as well.
3. The S corporation election must typically be made by the fifteenth day of the third month of the tax year for which the election is intended to be effective, or at any time during the year immediately preceding the tax year.
4. If a corporation that has elected to be treated as an S corporation ceases to meet the requirements (for example, if as a result of stock transfers, the number of shareholders exceeds 100 or an ineligible shareholder such as a nonresident alien acquires a share), the corporation will lose its S corporation status and revert to being a regular C corporation. Once it is reverted, the C Corporation has a 5-year waiting period to re-elect to be taxed under Subchapter S. If passive investment income exceeds gross profit by 25% for 3 consecutive years, the corporation will lose its S corporation status and revert to being a regular C corporation was well.

In general, an S corporation is exempted from federal income tax. The net business income or loss flows through Schedule K-1 and to be reported on the shareholders' individual tax returns. While net business loss will reduce the total income being taxed, shareholders may end up paying taxes at a higher bracket of income tax rates for their share of net business income, for example, from 15% to 28%. Therefore, election to be an S corporation may not be beneficial at all. Corporations and its shareholders must assess thoroughly before making the decision.

This article briefly discusses about business structures and the S Corporation. It should not be construed as all-inclusive; other steps may be appropriate for specific type of business. It is always to the employer's best interest to seek advices from tax professionals, IRS and or the appropriate state agency.

Excerpt from IRS website