

BOOKS ON FIRE. TAX AND ACCOUNTING AGENCY.

# COMPLETE GUIDE TO S-CORP

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Let's start with, what is an S-corp is a closely held corporation that made a valid election to be taxes under Subchapter S Chapter 1 of the Internal Revenue Code.

## Rules to qualify for S-election

- be a domestic corporation
- have no more than 100 shareholders
- have only one class of stock
- not be an ineligible corporation (i.e. certain financial institutions, insurance companies, and domestic international sales corporations)
- have only allowable shareholders like
  - certain trusts, estates, and individuals who are a U.S. citizens or resident alien
- all shareholders must agree to have an S-corp election
- shareholder / employee can get paid reasonable compensation for their position

# Disadvantages

- Corporations are required by the IRS to follow the calendar year as the tax year. Many other entity types have the freedom to choose any tax year type
- S corporations in most states file documents annually with the state and pay a filing fee. In some states, S corporations are required to pay a minimum franchise tax “for the privilege of doing business” in the state. Such requirements do not apply to sole proprietorships and general partnerships
- Shares of S corporations' shareholders can be seized and sold through court action. Such actions might be difficult with the other small business entity types
- The income of an S corporation's shareholder is taxed whether it is distributed out to the shareholders or reinvested
- Owner/employees holding 2% or more of the company's shares cannot receive tax-free benefits

- If tax status is compromised by either non-resident stockholder or stock being placed in corporate entity name, the IRS will revoke status, charge back-taxes for 3 years and impose a further 5-year waiting period to regain tax status.
- For assets that appreciate in value with time, the capital gains from the sale are generally higher if the business is an S corporation as compared to other small business types
- In an effort to prevent s corporation owner-employees from dodging employee taxes, the IRS forces S corporations to pay “reasonable” salaries to all employee-shareholders and of the corporation. This requirement applies regardless of whether the company is making a profit or not. This can stifle the growth of a new S corporation

# What is Reasonable Compensation

There are some factors that you need to take into consideration when determine "reasonable compensation"

- training and experience
- daily duties and responsibilities
- time and effort devoted to the business
- dividend history
- size and complexity of the business
- compensation to non-shareholders employees
- timing and manner of paying bonuses to key people
- what comparable businesses pay for similar services
- compensation agreements
- the use of a formula to determine compensation

Each year, when you complete the income tax forms for your corporation or S corporation, you must report corporate officer salaries if the corporation's total receipts are \$500,000 or more. You will need to use IRS Form 1125-E - Compensation of Officers, listing compensation for each corporate officer, along with information about the percentage of time devoted to the business and the percentage of stock owned by this officer.

# Advantages

- Limited liability for management and shareholders
- Distinct, court-recognized existence, which helps protect you from personal liability that can cause you to lose your personal wealth in assets like your home, car, or nest egg
- Your business will continue to exist even if the owner leaves, retires, or dies
- Your company can attract investors through the sale of shares of stock, giving you investment opportunities for the continued growth of your business
- Great income-splitting potential for owner/employees. Can take a smaller salary and pay income taxes and regular payroll deductions, then take the remainder of profit as a distribution subject to income tax only
- Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income.

# What is pass-through taxation

Pass-through income from an S-corp is a share of the business's profits, reported directly on shareholder's personal tax return.

The big benefit of it is that S-corporation shareholder doesn't have to pay self-employment tax.

The reasonable salary is of course a subject to Social Security and Medicare taxes paid 50/50 by employee and corporation.

## EXAMPLE:

I'm Tatyana, a single-owner of my S-corp Books on Fire, a tax agency. My revenue from business is \$80,000 per year. I paid myself a salary of \$40,000 per year and my annual expenses were \$15,000. Therefore, S-corp's net profit is \$15,000 for the year.

I paid Social Security and Medicare tax on \$40,000 (50% was paid by corporation, 50% was taken out of my paycheck).

S-corp's net profit of \$15,000 will show on my personal tax return as pass-through income and I will only have to pay an Income tax on it.

If Books on Fire wasn't an S-corp, I would ended up paying Self-employment tax on full \$65,000.

# How and when to form / elect an S-corp status

Every business that files for corporation status, get C corporation status first. After that process is complete, you have to elect Subchapter S by filling form 2553 and meet all the necessary requirements that we went over in "Rules to qualify" section of this guide.

To apply for S-corp status:

- Draft and file an Articles of Incorporation
- Prepare the corporate bylaws to summarize company rules surrounding operations, officer positions and duties
- Keep corporate minutes of all board and shareholders meetings
- Issue stock certificates to the initial shareholders
- File the IRS form 2553 within 75 days of your corporation formation or 2 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



# How we can help

As an Enrolled Agency, we have helped many business owner across all 50 states to properly elect S-corp status, and we would love to help you as well. If you are looking for some expert help to make a switch, please email us at [tatyana@booksonfire.accountant](mailto:tatyana@booksonfire.accountant)