How to Know if the S Corporation is Your Best Choice in Entity Structure

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You have a lot of details to consider when it comes to choosing the entity structure for your business. You can run it as a sole proprietorship, a single-member LLC, an S corporation, or a C corporation. How do you know which is the best choice? One of the biggest considerations is how your choice in entity structure affects your tax bill, and that’s exactly what this article looks at—specifically focusing on the pros and cons of the S corporation.

What an S Corporation Is

An S corporation is basically a federal tax election status. Your company can be formed as either an LLC or a corporation and still make the S corporation election.[1] That means your business name could end with (and legally be) “LLC”, but for tax purposes, you file as an S corporation. This tax status allows your company’s tax credits, deductions, and income to pass through to you as shareholder. For the right kind of business, this could grant liability protection with the benefits of personal taxation.

Knowing the Rules

In order to qualify for S corporation status, you only need to meet a few rules that are fairly easy for singly-owned businesses (or even husband-wife ownership teams):[2]

- You must be a domestic corporation (LLC’s are included in this designation).
- You must have no more than 100 shareholders.
- Each individual shareholder must be either a US citizen, resident alien, or estate. Certain types of trusts and tax-exempt entities may also be shareholders.
- Your business must carry one class of stock only.

So, the real question is: does an S corporation election make sense for your business?

Pros and Cons

No matter which entity structure you choose, you’ll come across both advantages and disadvantages. There is no one choice that works for every business and consistently generates the most tax advantages. You will need to do your research and make the best determination for you and your company. That being said, weighing the tax savings is an important part of the decision-making process.

Here are the positive tax implications for electing S corporation status:

- **You Pay Less in Payroll Taxes—**Operating as an S corporation makes the owner both a shareholder and an employee. This means you 1) receive distributions for your investment in the business, and 2) receive a salary for the work you do. The salary is paid to you by your corporation (because it acts as a separate entity from you as an individual), and thus is subject to payroll taxes. However, because you also receive income as an investor, you have the opportunity to pay yourself a lower wage (reducing your payroll taxes) and still make good money on the dividends. Of course, you should research what a reasonable wage would be—the IRS can ding you for paying yourself too little in salary.
- **You Can Split Taxable Income—**This can be a tax advantage if you want to provide money to someone, such as a parent. You basically have two options. You can give the money directly to your mom or dad as a gift, but this comes out of your after-tax dollars because you've already earned the money and must pay income tax on it. Alternately, you can give the parent a share in your company's stock, so that the gift money comes in the form of dividends. The second option is probably the better one if your parent is in a lower tax bracket than you are because you'll be able to provide the same amount of cash with less going to taxes.

For example, your parent is in the 10 percent tax bracket and you're taxed at 35 percent. You have to make $15,385 at your tax rate in order to give an after-tax gift of $10,000. But, if you give stock that earns $11,111, your parent still gets $10,000 after their 10 percent taxes. Of course, the second method also means your parent is now part owner in the company, so you'll have to weigh the consequences. Note that this strategy is not a good choice for splitting income with your children because they will be subject to the kiddie tax for investment income over $1,900 if they are younger than 19 or in college and younger than 24.[3]

- **You Avoid Double Taxation—**In general C corporation dividends are taxed at 15 percent. In addition, a C corporation is in the 15 percent income tax bracket for the first $50,000 it earns; however, the income tax percentage jumps up to 35 percent if your business is a personal service corporation, and you still have to pay taxes on dividends on top of that. If your corporation's income exceeds $50,000, it has moved into the 25 percent income tax bracket. You can see that the numbers keep creeping up, since the amount you'll earn (and pay taxes on) in dividends depends upon what's left after income taxes. With an S corporation, you are likely to avoid this frustrating situation.

With these advantages, you may already be considering taking the S corporation election, but remember that no entity is a perfect choice all around.

Here are some reasons you may decide not to go with an S corporation for tax purposes:

- **You'll Have Corporate Paperwork (and Extra Fees)—**If your business currently operates as a sole proprietorship, you're in the easy situation of paying your taxes on Schedule C of Form 1040. However, if you switch to an S corporation, you will take on all the corporate tax paperwork that comes along with it. Remember, your corporation will be a separate entity from you as an individual, so you will have paperwork for each. Pretty much any time money goes anywhere between you and your corporation, you'll have more required paperwork to fill out. Because you probably have neither the time nor the expertise to handle all of these tax, accounting, and legal documents, you'll likely need to pay for a tax preparer (and/or accountant) and lawyer. When you operate as a sole proprietor or single-member LLC, in contrast, you and your business share assets, and money can flow more easily between the business and yourself (but you should still keep the finances separate!).
- **Your Assets are Not Yours—**As mentioned above, a sole proprietorship or single-member LLC has one set of assets, and they belong to the business owner. But, when you create an S corporation and designate business assets, you no longer own those items—the corporation does. This means you'll be watched much more closely regarding how assets are used, and taking company assets for personal use can trigger a taxable event. Of course, even sole proprietors must watch out for Section 179 recapture rules.
- **You May Have to Pay Extra State Taxes—**Some states require S corporations to pay state income taxes or franchise taxes. And, here's the bigger kick in the teeth, it's not offset by any additional personal tax deductions for you.
- **Your Heirs May Have Higher Taxes—**Upon your death, a sole proprietorship or single-member LLC's assets are valued individually at fair market value, which usually means lower taxes for your heirs.[4] For a corporation, on the other hand, the company's stock is marked up to fair market value, and this could be much different from the value of the individual assets.
- **You Get No Break on Medical Costs—**If you're a more than 2 percent owner in your corporation, you won't be getting much in tax benefits for your health insurance, and neither will your spouse. You see, attribution rules dictate that your spouse has the same ownership interest as you. So, if you're a 100 percent owner, your spouse also has 100 percent interest in the company. This also means you cannot provide your employee-spouse with a Section 105 medical reimbursement plan, unlike the owner of a sole proprietorship or LLC. The Section 105 benefits are not counted as W-2 income.

- **You Have to Pay Payroll Taxes for Your Employed Children—**A proprietorship and single-member LLC both get the benefit of no payroll taxes for wages earned by their own underage children. They also don't pay Medicare, FICA, or employment taxes for the owner's kids. Unfortunately for S corporation owners, both the corporation and the child will be subject to payroll taxes.
- **You May Lose Out on 401(k) Contributions—**Because your S corporation income is divided between salary and distributions, you'll have less money available to contribute to your retirement plan. Contributions are based on your salary, and you'll probably have kept this amount low in order to save on self-employment taxes.

If none of these disadvantages deters you, then an S corporation may be a good fit for your company. The main reason to opt for an entity structure other than sole proprietorship is to attain liability protection. So, ask yourself how much liability protection you need for the type of business you're in, and then hire a tax professional to help you figure out which entity structure generates the biggest tax savings for you. You'll more than make back the money spent on professional advice in the years of tax-savings from choosing the appropriate entity structure.

1. IRC Section 1361(a)(1) ^
2. IRC Section 1361(b); Reg. Section 301.7701-3(c)(1)(v)(C) ^
3. IRC Section 1(g)(2); Rev. Proc. 2011-52 ^
4. IRC Section 1014(a) ^