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What is an S-Corp Election?



Business owners often struggle with determining the optimal legal structure and tax treatment for their business. Many are familiar with the S-Corp election but are fuzzy on the details and unsure when to make the election. This document will explain an S-Corp election and how you might benefit from the election.

When starting a business, an owner must determine its legal structure - a sole proprietorship, corporation, partnership, or LLC. After choosing a legal structure, the owner can decide on the optimal tax treatment for the income generated by the business. Depending on the legal structure, a business may be taxed as a C-Corp, S-Corp, Partnership, or Sole Proprietorship.

An S-Corp is a tax election defined by the IRS and not a legal structure. An LLC or corporation can elect to be taxed as an S-Corp by filing IRS Form 2553, as long as it meets certain requirements. The effect of the S-Corp election is different for an LLC than a corporation, so it's important first to understand how these two legal structures work by default.

Corporations are taxed as C-Corps by default. C-corps are taxed on their profits at the corporate level, and then shareholders are also taxed on any dividends they receive at an individual level. This can lead to what is known as double taxation, as the company and its owners are effectively taxed twice on the same income.

LLCs are generally taxed as a Partnership or a Sole Proprietorship by default. All business income is passed through to the owners and is subject to self-employment tax up to certain limits. Any compensation they receive is considered a cash distribution.



What are the benefits of an S-Corp election?

The benefits of an S-Corp election differ based on whether the legal structure is a corporation or an LLC.

For corporations, an S-Corp election removes taxation at the corporate level. Taxable non-wage income from the entity flows through to the owners, eliminating double taxation.

An owner of an S-Corp can receive wage compensation as an employee. Wages from an S-Corp are subject to employment tax, so the business and employee pay FICA and Social Security taxes. But with an S-Corp, business income net of the wages is passed through to the owner and is not subject to employment tax.

LLCs with an S-Corp election also allow owners to take wage compensation, which is subject to employment tax. However, the remaining taxable business income is passed through to the owner and is not subject to employment tax.

Regardless of legal structure, owners of an S-Corp benefit from minimizing the amount they take as wages, which is subject to employment tax, and maximizing the amount they receive as business income which is not subject to employment taxes.

Owners must be careful, though, to receive reasonable compensation for the services rendered in the eyes of the IRS. Otherwise, the IRS has the right to reclassify non-wage distributions made to the owner-employee as wages.



Who can use an S-corp election?

As a rule, S-corps cannot be owned by corporations, partnerships or foreign persons and can only have a maximum of 100 shareholders. If your business meets these requirements, it can elect to be taxed as an S-Corp, regardless of its corporate legal structure.

When is it best to use an S-corporation?

If you have an LLC, an S-Corp election may be beneficial unless your salary reduces your taxable income to zero or below. In that case, the primary tax advantage of the S corporation disappears, and you should take a closer look at operating the business as a sole proprietorship or partnership. However, if you plan to pay yourself a reasonable salary and the business still generates significant income, then an S-Corp election could save you money on self-employment taxes.

In some cases, an S-election by an LLC can also create a taxable event, so you should consult with our office prior to making an S-election.

If you have a corporation that is taxed as a C-corporation, it's almost always beneficial to elect S-corp status to avoid double taxation, unless pass through taxation would force you into a much higher tax bracket. Be aware that certain C-corp tax can still apply to an S-corp for the first five years after making an election.



Final Thoughts

This document is intended to provide a brief overview of S-Corp elections and is not a substitute for consulting with one of our expert advisors. If you'd like to discuss whether or not your business would benefit from a S-Corp election, please contact our office.



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