THE MYTHS OF CORPORATE FORMATION AND COMPLIANCE
PART II – THE "S" CORPORATION EXPLAINED

Myth: In order to form an S-Corporation, I only need to file the Articles of Incorporation.

It is not true that a corporate entity is fully formed with the filing of the Articles of Incorporation (or in the case of a Limited Liability Company, the Articles of Organization). Many times the questions are asked, "I formed my new corporation by filing the Articles of Incorporation, now what do I need to do?" and "My CPA recommended an S-Corporation, now what do I do?"

Filing the Articles of Incorporation is just the beginning of setting up and establishing a corporation. There are many further actions to take and documents to prepare including the preparation and adoption of the Bylaws and the many transactions that occur prior to the stock issuance and exempting the stock from registration with the Department of Corporations. Those transactional topics are explained and outlined in Part I, "*The Myths of Corporate Formation and Compliance."*

Myth: Anyone can file an S-Corporation.

An "S-Corporation" is a regular corporation that has between 1 and 100 shareholders and that passes-through net income or losses to shareholders under in accordance with Internal Revenue Code, Chapter 1, Subchapter S. Corporations must meet specific eligibility criteria, and they must notify the IRS of their choice to be taxed as an S-Corporation within a certain period of time (see below for discussion of the filing deadline.) The company is taxed as a sole proprietor or partnership rather than as a separate entity. Corporate profits and losses are "passed through" and reported on the personal income tax returns of the shareholders.

A regular corporation, sometimes called a "C" Corporation (after Subchapter C of the Internal Revenue Code), is taxed as a separate business entity. Corporations have their own tax form (1120) and their own tax rates (C Corp tax rates). Corporations may choose to retain their profits and earnings as part of their operating capital, or they may choose to distribute some or all of their profits and earnings as dividends paid to shareholders. Dividends paid to shareholders are essentially taxed twice. They are taxed once at the corporate level (on the corporation's Form 1120), and again at the individual level (on the person's Form 1040).

An S-Corporation is not subject to corporate tax rates. "Generally, an S-Corporation is exempt from federal income tax other than tax on certain capital gains and passive income," according to the Internal Revenue Service. Instead, an S-Corporation passes-through profit (or net losses) to shareholders. The business profits are taxed at individual tax rates on each shareholder's Form 1040. The pass-through (sometimes called flow-through) nature of the income means that the corporation's profits are only taxed once – at the shareholder level. The IRS explains it this way: "On their tax returns, the S-Corporation's shareholders include their

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share of the corporation's separately stated items of income, deduction, loss, and credit, and their share of nonseparately stated income or loss." S-Corporations therefore avoid the so-called "double taxation" of dividends.

S-Corporations, like regular C-Corporations, can decide to retain their net profits as operating capital. However, all profits are considered as if they were distributed to shareholders. Thus an S-Corporation shareholder might be taxed on income they never received. (Whereas a shareholder of C-corporation is taxed on dividends only when those dividends are actually paid out.) In an S-Corporation, each shareholder/owner must share in the income in direct proportion to their ownership. If you and a partner each own 50% of the business, you each will be taxed on 50% of the profits, regardless of any other agreements you might make about splitting up the profits.

A corporation may choose to be taxed as an S-Corporation if it meets the following criteria: The company is (a) a domestic corporation, or (b) a domestic entity eligible to elect to be treated as a corporation that timely files Form 2553 and meets all the other tests listed below.

1. An S-Corporation cannot have more than 100 shareholders.
2. All shareholders in an S-Corporation must be individuals (not LLC's or partnerships) and legal residents of the United States.
3. An S-Corporation can have only one class of stock, so all owners must share equally in terms of profits and losses based on their percentage of ownership.
4. Generally, and with some exceptions, adopt a tax year ending December 31.
5. Each shareholder consents to the S-Corporation election.

Myth: There are no tax advantages to an S-Corporation and I can file the S-Corporation election at any time.

The primary questions often asked are, "are there tax advantages to an S-Corporation compared to an LLC?" and "Can I file for an S-Corporation at any time."

An S-Corporation may have several potential tax advantages as compared to an LLC, however it is important to understand how to set up an S-Corporation or an LLC as well as the default rule that apply to LLC taxation. There is also a quick deadline to meet after the filing of the Articles of Incorporation to file the "S" election paperwork (IRS Form 2553). If the deadline is missed the consequences result in the filing of two separate tax returns; one for the C-Corporation and one for the S-Corporation. For this reason, advice from counsel should be obtained as to the timing as well as the timing of filing the Articles of Incorporation, especially if you are at the end of the year.

Setting Up an S-Corporation or LLC

S-Corporations are created when an eligible entity (traditionally a corporation but also potentially a limited liability company) *elects* to be treated according to the rules of Subchapter S of the Internal Revenue Code and its related regulations. Therefore, S-Corporations are really a

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tax accounting classification rather than a legal entity. An LLC, in contrast, is actually a legal entity created by state law through the filing of articles of LLC formation or some similar document. Note that some professions are prohibited from forming as an LLC. Consult with your legal counsel for further information about your particular business and/or profession.

<u>Default Tax Rules for Limited Liability Companies ("LLC")</u>

While an LLC may typically make an election to be treated as an S-Corporation, if the LLC doesn't make this election, the tax accounting depends on *whether the LLC is owned by one member or more than one member.* LLCs with one owner, or "member", can be disregarded (or ignored) for tax purposes. And this "ignoring" or "disregarding" just means that the LLC's activities are reported on its owner's regular income tax return with the issuance of a form K1.

An LLC with multiple owners, or "members," can be treated as a partnership for tax purposes. In this case, the LLC files a partnership tax return and the partnership tax rules apply. Thus, the LLC, as a legal entity, can elect to use the S-Corporation tax accounting classification.

<u>Tax Advantages of an S-Corporation vs. Single-member LLCs</u>

A single-member LLC treated as a disregarded entity reports its income and deductions on a Schedule C tax form, if the LLC operates an active trade or business. This tax accounting means that the LLC owner pays self-employment taxes (roughly 15% on the first $100,000 of profits and roughly 3% therefore) on all of the LLC's profits. Note that it is expected these tax rates will be increasing in the near future.

By contrast, a single-member LLC operating an active trade or business and treated as an S-Corporation has to file a corporate tax return and regular payroll tax returns. However, the S-Corporation status means that the business pays Social Security and Medicare taxes equivalent to self-employment taxes (again roughly 15% on the first $100,000 of profits and then 3% on profits after that) only on the amount of profit called "wages."

For example, if an LLC makes $100,000 in profits and the LLC is treated as a sole proprietorship, the self-employment tax bill roughly costs $15,000 each year. If the LLC is treated as an S-Corporation and the owner, wage amount is set to $50,000.00; the self-employment tax bill roughly costs $7,500 each year. The S-Corporation status in this example saves the owner roughly $7,500 annually in employment taxes. Note: A single-member LLC that <u>does not</u> operate an active trade or business doesn't have to pay self-employment tax and so would not save self-employment taxes by electing S-Corporation status.

<u>Tax Advantages of S-Corporation vs. Multiple-member LLC's</u>

A multiple-member LLC is treated as a partnership *unless* it makes an election with the IRS to be treated as a regular C-Corporation *or* as an S-Corporation. As compared to a multiple-member LLC, an S-Corporation provides two significant advantages. First, a partner's earnings from a partnership engaged in an active trade or business are subject to self-employment taxes.

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Accordingly, by electing to have a multiple member LLC treated as an S-Corporation, the LLC saves the owners self-employment taxes in the same way that an LLC treated as a sole proprietorship saves its owner self-employment taxes.

By way of example, if an LLC makes $200,000.00 in profits and has two members who each receive half of the profits and the LLC is treated as a partnership, each partner receives $100,000.00 of earnings and each partner's self-employment tax bill roughly costs $15,000.00 each year.

If the LLC is treated as an S-Corporation and the owner wage amounts are set to $50,000.00, the self-employment tax bill roughly costs $7,500.00 per partner each year. The S-Corporation status in this example saves each partner roughly $7,500 annually in employment taxes.

Note: If an LLC with multiple members has both members who actively work in the business and other members who can't make decisions and don't work in the business, a special type of LLC can be created that also provides for self-employment tax savings even though the LLC is treated as a partnership. Typically, only large LLCs will have the resources to pay for the attorney and accountant help necessary to set up and cleanly operate one of these special LLCs. This type of LLC is special and is set up to comply with proposed Treasury Regulations dealing with LLCs that resemble limited partnerships by having both active, "general partner"-like members and passive, "limited partner"-like interests. An LLC treated as a partnership requires more complicated and more expensive accounting than an LLC treated as an S-Corporation.

Myth: I can make my "S" election at any time without penalty or cost.

A corporation files IRS Form 1120S, U.S. Corporation Income Tax Return for any tax year before the year the "S" election takes effect. Once the "S" election is made, it stays in effect until it is terminated or revoked.

The S-Corporation Deadline

It is extremely important for a newly formed corporation to make the decision to be taxed as an S-Corporation instead of as a C-Corporation early. IRS Form 2553, Election by a Small Business- Corporation under Section 1362 of the Internal Revenue Code, *must be filed no later than two months and fifteen days after the date of formation* (the filing date of the Articles of Incorporation) if the corporation is making the election effective for its first tax year in existence. The IRS will send a notification approving of the "S" election, which should be filed within the corporate records book and a copy provided to your CPA.

Each shareholder who owns stock on the day the election is made needs to consent to the election by executing the form. If a husband and wife have a community interest in the stock or in the income from it, *both* must consent. There are other signature requirements that may be unique to your corporate shareholder structure, and advice of counsel should be obtained.

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Normally, if a corporation that files Form 2553 after the 15th day of the third month of its tax year but before the 15th day of the third month of the following tax year, then the IRS considers the S-Corporation election to be valid for the *following tax year and not valid for the preceding year.* If you have decided to make an "S" election and have not timely filed for such, you can still file Form 2553 and still receive IRS approval to make the election retroactive to the beginning of the corporation's tax year. *There are rules to follow and several criteria which need to be met and which can be explained by your counsel and /or CPA.*

If the election is not made timely, the result can be costly. Duplicate franchise tax fees and duplicative tax returns may be required. While there is an exception to a late filing plea that can be made to the IRS, such procedure adds further CPA and potential legal costs. The procedure for filing a late "S" election is somewhat technical, and most business owners will probably want to have professional help if they have missed the deadline for making the election.

A Final Word

In order to maintain your corporate liability protections it is crucial to keep your corporate records up to date and the annual filings, including the corporate tax return, timely. Corporate records governance and compliance and keeping such up to date is crucial to asserting a defense in litigation and be able to commence litigation as well as defend litigation through the corporate entity and shield your personal assets and wealth.

Taking the time to effectively communicate with your corporate counsel and allowing the corporate governance process to occur on at least an annual basis by your counsel is essential to maintaining the corporate liability protections. Staying in compliance with California corporate laws is overwhelming. Tamara L. Harper, Esq. advocates and protects not only your corporate interests but also your employment and labor law liability exposure.

Tamara L. Harper's unique competitive advantage is that she is very approachable as an attorney, which makes her clients feel at ease and in capable hands and further brings twenty years of litigation experience as a trial attorney to the drafting table. Tamara Harper, Esq. is an aggressive fighter that is reliable and ethical. Ms. Harper not only offers quality work, but enjoys a good location in Westlake Village, California. Tamara L. Harper prides herself on her good personal and business relationships with clients, and uses her insight and knowledge to obtain successes for each client.

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