

The Advantages of forming an S-Corporation

There are several decisions to consider when forming a business entity; it is important to be familiar with the tax ramifications of a given business entity before it is filed with the designated state agency. Forming an S-Corporation is one of several options when deciding which type of business entity to form; other options include the LLC and C-Corporation. There are several practical and legal concerns to take under consideration as you determine how to structure your business. You must establish whether or not your company will go public, you also need to consider the number of partners or shareholders within the company, and, perhaps most importantly, explore all the tax ramifications of each business entity. With all these considerations in mind, there are some distinct advantages to choosing the S-Corporation as your business entity.

One advantage of the S-Corporation is that like the LLC it receives pass through taxation. Pass through taxation simply means that federal income tax is not assessed at the entity level; profits are distributed in the form of dividends and flow through to the individual tax returns of the shareholders, and the IRS taxes the shareholders at their individual income tax rate and not at the entity or corporation level. Therefore the S-Corporation, unlike the C-Corporation, is not subject to double taxation. Since net losses are "passed through" as well, the individual shareholder may be able to reduce his or her tax liability by offsetting other income with any S-Corporation losses. One of the most enticing advantages of the S-Corporation is its ability to minimize payroll / self employment taxes which can be a significant amount of money, currently the rate is set at 15.3%. For example let's take an S-Corporation with a single shareholder, if the company was to have a net profit of \$90,000.00 and the shareholder employee assigned himself a salary of \$25,000.00 he would be able to reduce payroll / self employment taxes by \$9,945.00. This is because only the \$25,000.00 salary portion would be classified as earned income and subject to payroll / self employment taxes, the remaining \$65,000.00 would pass through as a non-qualified dividend. While taxed at the personal income tax rate of the shareholder, the \$65,000.00 is exempt from the self-employment / payroll taxes.

Companies doing business as an LLC have the same advantage of pass through taxation; however a single member LLC is treated as a disregarded entity by the IRS. The business entity is disregarded as a separate entity from its owner for Federal tax purposes; essentially what this means is that the IRS classifies the single member LLC as a sole proprietorship and since all income from a sole proprietorship is treated as earned income the full \$90,000.00 would be subject to the 15.3% payroll / self employment tax. For this reason, an S-Corporation could be viewed as a superior entity choice for the individual owner who is looking to minimize his or her payroll and self-employment tax exposure.

A multimember LLC is treated by the IRS as a Partnership as the default status for federal tax purposes. This requires that the LLC file the Form 1065 Partnership return (informational only – the LLC does not pay federal taxes), and the net income (or loss) passes through and is accounted for on the tax returns of each individual member.

Companies doing business as S-Corporation must first form a standard corporation with the state (and the default federal tax status at that point is that of a C-Corporation). After the corporation is formed with the state the company must file an IRS Small Business Tax Election form 2553 stating their intention to be taxed as an S-Corporation. IncFile prepares the Form 2553 and returns it to you for your signature along with your filed corporation, and after the initial shareholders have signed it can simply be faxed or mailed in to the IRS. The IRS Form 2553 must be signed and submitted to the IRS within 75 days of the date of formation of the corporation.

About the Author

[S-Corporation Tax Savings Calculator](#) may help reduce income/payroll taxes. [To learn more about S-Corporations](#) look to IncFile for company formation services.

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