

Considering an S-Corporation

The S corporation is often more attractive to small-business owners than a standard (or C) corporation. That's because an S corporation has some appealing tax benefits and still provides business owners with the liability protection of a corporation. With an S corporation, income and losses are passed through to shareholders and included on their individual tax returns. As a result, there's just one level of federal tax to pay.

A corporation must meet certain conditions to be eligible for a subchapter S election. First, the corporation must have no more than 75 shareholders. In calculating the 75-shareholder limit, a husband and wife count as one shareholder. Also, only the following entities may be shareholders: individuals, estates, certain trusts, certain partnerships, tax-exempt charitable organizations, and other S corporations (but only if the other S corporation is the sole shareholder).

In addition, owners of S corporations who don't have inventory can use the cash method of accounting, which is simpler than the accrual method. Under this method, income is taxable when received and expenses are deductible when paid.

S corporations do come with some administrative 'housekeeping' items that are typically handled on an annual basis. They must file articles of incorporation, hold directors and shareholders meetings, keep corporate minutes, and allow shareholders to vote on major corporate decisions. In a single-owner scenario,

these tasks can usually be accomplished by completing a few worksheets which should take a minimal amount of time.

S corporations aren't without their advantages, however. One person can form an S corporation, while in a few states at least two people are required to form an LLC. Existence is perpetual for S corporations. Conversely, LLCs typically have limited life spans.

The stock of S corporations is freely transferable, while the interest (ownership) of LLCs is not. This free transferability of interest means the shareholders of S corporations are able to sell their interest without obtaining the approval of the other shareholders. In contrast, member of LLCs would need the approval of the other members in order to sell their interest. Lastly, S corporations may be advantageous in terms of self-employment taxes in comparison to LLCs.

A typical structure for an S-corporation is the loan-out scenario. An S-corporation is formed, and subsequently contracts for services are made between the customer and the Corporation for the services of the shareholder-employee. Tax rules require an S-Corporation to pay its shareholder-employee a 'reasonable salary' for services rendered to the customer on behalf of the S-Corporation.


Currently thinking is that a reasonable salary should be based on several factors including the activity level and net income of the Corporation, the type and level of services being performed, the amount of work being performed by non-shareholder employees, and several other factors.

Should we decide that an S-corporation is right for your situation we will work with you throughout the year and at the end of the year to keep an eye on your net income. We will base your salary on the results of the year so as to not pay

too little, or too much, and thus maximize the savings afforded through the use of an S-corporation. Many S-corporation owners will do a nominal salary on a monthly basis throughout the year, and a payroll bonus at year end should their net income require a larger salary in order to be considered reasonable based on operating results.

I hope this has been informative and helpful, and we are always available should you have additional questions regarding incorporation, please don't hesitate to call.

Very truly yours,

A handwritten signature in black ink, appearing to read "Jani Ams". The signature is fluid and cursive, with a long horizontal stroke at the end.

Cottage & Associates, Inc.