CPA Practice Advisor

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Nellie Akalp • Oct. 10, 2019

With all the decisions your clients are expected to make when starting a business, which legal structure to choose might not get as much consideration as it should. Most business owners choose to form a sole proprietorship in the beginning, since it’s less paperwork and less costly; many switch entities as their business grows to benefit from the protections provided by a Limited Liability Company (LLC) or C Corporation. But an LLC or C Corp can also choose to elect S Corp status. If your clients come to you with questions about this option, here’s what to know:

The C Corp

The biggest reason your clients will choose to form a C Corp. is that corporations

In a true C Corp, the profits and losses are "owned" by the corporation only, and taxes are based on the corporation's activity. Business expenses, retirement plan costs and employee benefits are tax deductible to the corporation. Only dividends to the shareholders are taxable as the shareholder's income. This is referred to as "double taxation," as owners of the corporation pay taxes both on the corporation's profits and on their dividends.

C corporations are also a pricier choice for legal structure as they pay several state and federal filing fees in addition to the various city licenses and industry certifications a business may need. The steps to form a C Corp can also be cumbersome, as the law requires a corporation to:

- Select a Board of Directors, meet with the board regularly and keep detailed meeting minutes.
- Formally register the business by filing Articles of Incorporation with the state.
- Obtain a Tax ID Number or Employee Identification Number (EIN) from the IRS.
- Draft corporate bylaws. Corporate bylaws are the official rules for operating and managing the company, proposed and voted on by the Board.

Limited Liability Company (LLC)

As an alternative to the C Corp, your clients may choose to form a Limited Liability Company (LLC), which is a less stringent business structure than the C Corp, but still provides the owners a layer of protection from liability. The LLC is considered a separate legal entity from its members and is responsible for its own finances and legalities in the case of a lawsuit.

Unlike the C Corp, LLCs require less paperwork to set up. There's no board of directors, which gives the company more flexibility when making business decisions. Instead, the LLC's owners (called members) create and file the Articles of

Organization with the state and make the decisions. LLCs still need to acquire an EIN

to the Tax Cuts and Jobs Act).

The S Corp Election

There is another taxation option for C Corps and LLCs: Electing S Corp status. The S Corp isn't a legal business entity, but instead a special election made by your clients for tax purposes. The business still retains the liability protection of the C Corp or LLC, but by electing S Corp status, they now have pass-through taxation and are no longer taxed at the corporate level.

Why would a C Corp or LLC choose to elect S Corp status? The positives of the S Corp election come down to its income-splitting potential for owners of the LLC or C Corp. Members or owners can decide to take a reduced salary; pay income taxes, Social Security and Medicare taxes on the smaller salary; and take the remainder of their compensation in the form of dividends. Dividends are not subject to self-employment tax, so this dividend distribution is subject to income tax only.

Because the profits are passed through to the individuals, the S Corp is not necessarily beneficial to companies with high earnings. There are also limits on the number of shareholders an S Corp can have, so this election might not work for clients who plan to solicit investors.

For startups or other businesses with losses, however, S Corp losses can be written off on the client's personal tax returns, which may be beneficial.

To qualify for S-Corp status:

- The business must be a U.S. corporation or LLC
- It can maintain only one class of stock
- It's limited to 100 shareholders or less
- Shareholders must be individuals, estates or certain qualified trusts

- Each shareholder must consent in writing to the S Corporation election

corporation. And you can convert back to an LLC at a later date if you so choose. In California, with LLCs your California Secretary of State registration is still every other year (LLC) instead of every year for (corporations).

With the 199A deduction, S status may be of real benefit since shareholder wages are considered in the calculation of the benefit, but guaranteed payments are not.

I still believe that a corporation with an S election provides better legal protection than an LLC.

Your clients have until March 15 to elect S Corp status by filing Form 2553 with the IRS. If your client happens to miss the deadline, the business will continue to be taxed as a C Corp or LLC for the current tax year, and the S Corp will kick in the following year. Your client can receive an automatic six-month extension to file for S Corp status by filing IRS Form 7004.

Make sure to inform your clients that if the S Corp status is not as advantageous as they thought it would be, the company can revoke the status at any time—all it takes is a majority shareholder vote. The company can determine its own revocation date and if that date happens sometime during the tax year (as opposed to the end of the tax year), the client will need to file two separate tax returns, one as an S Corp and the other as the LLC or C Corp.

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Nellie Akalp is a passionate entrepreneur, business expert and mother of four. She is the CEO of CorpNet.com, a trusted resource and service provider for business incorporation, *LLC filings, and corporate compliance services in all 50 states. Nellie and her team recently*

Small Business