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Corps.

Nellie Akalp • Mar. 07, 2023



By Nellie Akalp.

There are many reasons for your clients to claim an S Corp election. Although the most significant advantage is the limited liability protection it provides its shareholders, the S Corp election also avoids the double taxation incurred by C Corps.

Milestones to Consider

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overall tax bill by dividing profits into salary and dividend payments.

For businesses structured as corporations, being an S Corp can help them avoid paying taxes at the corporate and shareholder levels. For a limited liability company (LLC), S Corp owners/shareholders can be employees and receive dividends—and they only pay self-employment taxes on the salary portion—saving money on taxes.

The self-employment tax rate is 15.3% (12.4% for social security and 2.9% for Medicare). Therefore, for each dollar of profit they earn, your clients could potentially save 15.3%. Depending on the business's profits, you can help your clients determine if and when electing to be an S Corp makes sense.

Another milestone to consider is if your client wants to offer stock now or in the near future. LLCs can't offer stock. If your client is or wants to form a C Corp, they must determine how many authorized stock shares the corporation will have as soon as possible. If they ever want to change that number of authorized stock shares, they will need to have a shareholder vote and amend the articles of incorporation. As an S Corp., your client can set aside a portion of shares that can be offered to future investors without having to amend the articles of incorporation or have a shareholder vote to increase authorized shares.

The IRS is Watching

The Internal Revenue Service (IRS) closely monitors S Corps owners to ensure they take (and pay) “reasonable salaries” to all employees. If the IRS believes salaries are below the typical wage for those positions because the business is trying to avoid paying payroll taxes, the company will lose its S Corp status. Although the IRS deems that “reasonableness is determined based on all the facts and circumstances,” a good rule of thumb is that any shareholder who does more than contribute money to the company should be considered an employee. If the company is flagged, the IRS will

study the S Corp's source of income (gross receipts) and who performed which tasks

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- The locality's cost of living
- The employee's abilities and achievements
- The amount of pay compared to the business's gross and net income

It may also be helpful for you or your clients to check the [U.S. Bureau of Labor Statistics](#) for comprehensive wage data searchable by occupation nationwide and comparable wages by state, region, and city.

Other factors to consider include which states do or do not recognize S Corps at the state level. Some states, such as New York, require corporations to elect S Corp at the state and federal levels. Other jurisdictions, such as the District of Columbia, Louisiana, New Hampshire, New York City, Tennessee, and Texas, don't recognize the federal S Corp election and tax S Corps as a corporation.

S Corp Qualifications

To qualify for S Corp status, your business clients must meet the following requirements:

- The business must be a domestic corporation or limited liability company (LLC)
- The business must only have allowable shareholders (individuals, certain trusts, estates, and specific exempt organizations—such as a 501(c)(3) nonprofit
- Shareholders cannot be partnerships or corporations
- Shareholders must be U.S. citizens or residents
- The S Corp can have no more than 100 shareholders
- The S Corp can have only one class of stock

S Corp Election Compliance

Now is a good time to remind your clients of the March 15 deadline to file IRS Form 2553 with the IRS to elect S Corp status. If they miss the deadline, the company

remains as is, and the S Corp election becomes effective the following tax year.

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Missing deadlines may mean penalty fees for your clients. Also, they can lose their S Corp status if they have too many shareholders or make more than 25% of the business's income from passive investment income.

Is it Time to Revoke the S Corp Election?

If your clients are already S Corps, they may reach other milestones where they decide that an S Corp election isn't working for them anymore. For example, companies with significant income may benefit from the 21% flat tax rate enacted by the Tax Cuts and Jobs Act of 2017 for C Corporations. Also, new in 2023, the [Inflation Reduction Act](#) imposes a corporate alternative minimum tax for companies with over \$1 billion in profits. In addition, the Inflation Reduction Act reduces costs for small businesses by "maintaining lower healthcare costs, supporting energy-saving investments, and bolstering supply chain resiliency."

Also, because S Corps are limited to 100 shareholders, businesses wanting to attract more shareholders/investors must revoke their S Corp election. Likewise, other stock restrictions, such as only offering one class of stock, shareholders having to be U.S. citizens, and never being able to go public, could make clients reconsider the S Corp election.

If your clients decide to revoke their S Corp election, the revocation deadline is the 16th day of the third month of the tax year. For example, the revocation must be filed by March 16 for the revocation to be active as of January 1.

Here's how your clients file for revocation:

1. A shareholder vote must be held and documented. At least 50% of voting and nonvoting shareholders must sign the document. (Although all shareholders must agree to elect S Corp status, revocation only needs a majority.)

2. A revocation statement must be forwarded to the IRS. It should include the

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of the name of the S corporation

1. The S corporation's EIN
2. The election to which the shareholder(s) revokes
3. The statement must be signed by the shareholder(s) under penalties of perjury
4. Signature and consent of shareholder(s) who collectively own more than 50% of the number of issued and outstanding stock of the corporation (voting or nonvoting)
5. Indication of the effective date of the revocation (or prospective date)
6. Signature of the person authorized to sign the return

Did your client miss the revocation deadline? The company will continue to be taxed as an S Corp for the remainder of the tax year, and revocation will occur the following year.

Nellie Akalp is a passionate entrepreneur, business expert, and mother of four. She is the CEO of [CorpNet.com](https://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 launched a partner program for accountants, lawyers, and business professionals to help them streamline the business incorporation and compliance process for their clients.

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