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C or S Corporation Choice is Critical for Small Business

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When an individual outgrew a proprietorship, a corporation used to be the norm. Today, limited liability companies (LLCs) are the new normal. See IRS: Forming a Limited Liability Company. But if you have a corporation—one you formed or inherited—should it be S or C? What does this alphabet soup even ***mean***?

Articles of Incorporation filed with your Secretary of State are the corporation's birth certificate, but they don't say if the corporation is S or C. All corporations are C corporations (under subchapter "C" of the tax code) unless they file for S status. If you take no action, your corporation is a C corporation.

Whether S or C, a corporation is entitled to limited liability. It's traditionally the reason businesses incorporate. It is also a structure people understand. A separate legal entity, it is owned by shareholders, ruled by a board of directors who elect officers to do day to day management.

But C vs. S status is all about taxes. File a one page "S election" with the IRS and it is taxed almost like a partnership or LLC. See IRS: S Corporations. A corporation may be taxed as a C corporation for many years and then change to S status. Alternatively, by filing the S election upon initial formation, it will never be a C corporation, so does not need to worry about the built in gain tax on conversion from C to S (more about that tax below). Of course, it could always convert later from S to C.

Income from a C corporation is taxed twice. The corporation pays tax on its net income. Then, shareholders also pay tax on distributions. Income from an S corporation is taxed once at the shareholder level.

Who is Eligible? An S corporation can have no more than 100 shareholders, only U.S. citizens and resident aliens, generally individual shareholders, and a calendar fiscal year. If there are multiple classes of stock, only differences in voting rights are allowed. For most small businesses, these criteria are easy to meet.

If the owners are more comfortable with the corporate form than with an LLC, an S corporation can be a good choice. However, the accounting rules for S corporations are complicated, and it is hard for existing C corporations to convert. An S corporation can face corporate tax if it was previously a C corporation and elected S status within the last 10 years (this is the built-in gain tax noted above). Many of these rules can be avoided if you start out with an S corporation. To do this, file your S election within 75 days of forming your corporation.

Bottom Line. How do you weigh the pluses and minuses on your facts? Usually, C corporations make no sense for small businesses due to double tax on income and on proceeds of sale. Besides, if you incur losses, you want to claim them personally, favoring an S. Whatever you do, get some advice, and pay attention to the tax rules.

For more, see:

Choice of Entity Poses Tax, Liability Issues

But Who Pays Tax On Business Sale?

Tax and Liability Dictate Business Form

Selling Your Business? Taxes Are Key

In Business? Get A Buy-Sell Agreement

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