Assessing the S corp

The S corporation business structure offers many advantages, including limited liability for owners and no double taxation (at least at the federal level). But not all businesses are eligible • and, with the new 21% flat income tax rate that now applies to C corporations, S corps may not be quite as attractive as they once were.

Tax comparison

The primary reason for electing S status is the combination of the limited liability of a corporation and the ability to pass corporate income, losses, deductions and credits through to shareholders. In other words, S corps generally avoid double taxation of corporate income — once at the corporate level and again when distributed to the shareholder. Instead, S corp tax items pass through to the shareholders' personal returns and the shareholders pay tax at their individual income tax rates.

But now that the C corp rate is only 21% and the top rate on qualified dividends remains at 20%, while the top individual rate is 37%, double taxation might be less of a concern. On the other hand, S corp owners may be able to take advantage of the new qualified business income (QBI) deduction, which can be equal to as much as 20% of QBI.

You have to run the numbers with your tax advisor, factoring in state taxes, too, to determine which structure will be the most tax efficient for you and your business.

S eligibility requirements

If S corp status makes tax sense for your business, you need to make sure you qualify • and stay qualified. To be eligible to elect to be an S corp or to convert to S status, your business must:

- Be a domestic corporation and have only one class of stock,

- Have no more than 100 shareholders, and
- Have only "allowable" shareholders, including individuals, certain trusts and estates. Shareholders can't include partnerships, corporations and nonresident alien shareholders.

In addition, certain businesses are ineligible, such as insurance companies.

Reasonable compensation

Another important consideration when electing S status is shareholder compensation. The IRS is on the lookout for S corps that pay shareholder-employees an unreasonably low salary to avoid paying Social Security and Medicare taxes and then make distributions that aren't subject to payroll taxes.

Compensation paid to a shareholder should be reasonable considering what a nonowner would be paid for a comparable position. If a shareholder's compensation doesn't reflect the fair market value of the services he or she provides, the IRS may reclassify a portion of distributions as unpaid wages. The company will then owe payroll taxes, interest and penalties on the reclassified wages.

Pros and cons

S corp status isn't the best option for every business. To ensure that you've considered all the pros and cons, contact us. Assessing the tax differences can be tricky — especially with the tax law changes going into effect this year.