TAX YEAR 2023

S Corporations

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What You Need to Know About S Corporations

S corporations are corporations that elect to pass income, losses, deductions, and credits through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations are responsible for tax on certain built-in gains and passive income.

To qualify for S corporation status, the corporation must meet the following requirements.

- It must be a domestic corporation.
- It must have only allowable shareholders.
  - Allowable shareholders include individuals, certain trusts, and estates.
  - Unallowable shareholders include partnerships, other corporations, and nonresident aliens.
- It must have no more than 100 shareholders.
- It must have only one class of stock.
- It may not be an ineligible corporation, such as certain financial institutions, insurance companies, and domestic international sales corporations.

In order to become an S corporation, the corporation must submit Form 2553, *Election by a Small Business Corporation,* signed by all the shareholders.

Corporate Formalities

Some or all of the benefits of establishing a corporation are lost when corporate formalities are not strictly followed. When a corporation is formed, a separate entity is created, with legal rights and responsibilities that are distinct and separate from the shareholders.

Corporate Veil

Corporations are often formed for purposes of protecting shareholders from liability. However, if formalities are not followed, the corporation is not adequately capitalized, or personal and corporation funds are intermingled, the corporate veil can be easily "pierced" by a court, which results in personal liability for the shareholders.

Reasonable Wages

Since a corporation is a separate legal entity, shareholders performing services for the corporation are treated as employees and must be paid reasonable wages for the duties performed. Even with a single-shareholder corporation, federal and state payroll taxes must be withheld and a year-end W-2 must be submitted, just as with any other employee.

IRS Issues

If tax formalities are not followed, such as reasonable wages being paid to shareholders, the IRS can reclassify income and expenses, causing unwanted tax consequences.