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A CRITICAL CHOICE... C or S Corporation?

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. 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. 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.

TAX GROUP

*“Income from a
C corporation is
taxed twice!”*

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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. 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.

S corporation vs. C corporation: Similarities

Form 2553 must be filed with the IRS and all S corporation guidelines met. But C corporations and S corporations share many qualities:

- Limited liability protection. Both offer limited liability protection, so shareholders (owners) are typically not personally responsible for business debts and liabilities.
- Separate entities. Both the S corp and C corp are separate legal entities created by a state filing.
- Filing documents. Formation documents must be filed with the state. These documents, typically called the Articles of Incorporation or Certificate of Incorporation, are the same for both C and S corporations.
- Structure. Both have shareholders, directors and officers. Shareholders are the owners of the company and elect the board of directors, who in turn oversee and direct corporation affairs and decision-making but are not responsible for day-to-day operations. The directors elect the officers to manage daily business affairs.
- Corporate formalities. Both are required to follow the same internal and external corporate formalities and obligations, such as adopting bylaws, issuing stock, holding shareholder and director meetings, filing annual reports, and paying annual fees.

S corporation vs. C corporation: Differences

Despite their many similarities, S corporations and C corporations also have distinct differences.

- Taxation. Taxation is often considered the most significant difference for small business owners when evaluating S corporations vs. C corporations.
- C corporations. C corps are separately taxable entities. They file a corporate tax return (Form 1120) and pay taxes at the corporate level. They also face the possibility of double taxation if corporate income is distributed to business owners as dividends, which are considered personal income. Tax on corporate income is paid first at the corporate level and again at the individual level on dividends.
- S corporations. S corps are pass-through tax entities. They file an informational federal return (Form 1120S), but no income tax is paid at the corporate level. The profits/losses of the business are instead “passed-through” the business and reported on the owners’ personal tax returns. Any tax due is paid at the individual level by the owners.

- Personal Income Taxes. With both types of corporations, personal income tax is due both on any salary drawn from the corporation and from any dividends received from the corporation.
- Corporate ownership. C corporations have no restrictions on ownership, but S corporations do. S corps are restricted to no more than 100 shareholders, and shareholders must be US citizens/residents. S corporations cannot be owned by C corporations, other S corporations, LLCs, partnerships or many trusts. Also, S corporations can have only one class of stock (disregarding voting rights), while C corporations can have multiple classes. C corporations therefore provide a little more flexibility when starting a business if you plan to grow, expand the ownership or sell your corporation.



Making the S corporation (S corp) election

To become an S corporation, you must file Form 2553 with the IRS. The IRS instructions—which can be a bit tough to follow (assistance from a professional is suggested) require that an election is considered effective in the current tax year only if the Form 2553 is completed and filed:

- Any time before the 16th day of the 3rd month (for calendar year tax payers, this means it needs to happen by March 15th)
- Any time during the preceding tax year (however, an election made no later than 2 months and 15 days after the beginning of a tax year that is less than 2½ months long is treated as timely for that year).

Generally, an election made after the 15th day of the 3rd month but before the end of the tax year is effective for the next tax year (unless you can show failure to file on time was due to reasonable cause).

Keep in mind that some states also require you to file a state-level S corporation election after incorporating your business.

For additional guidance on which structure to choose; S corporation vs. C corporation, contact a specialist at GALLINA LLP, CPAs today.

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