

Subchapter S Corporations

Have you considered incorporating your business? If so, one of the options available to you is a “Sub S” corporation. A Sub S corporation is a corporation formed under Subchapter S of the Internal Revenue Code. It is an election that you file with the IRS that allows you to operate a business as a Sub S corporation under the income tax rules established for them.

A Sub S corporation reports its profits and losses as distributions which are passed directly to the shareholders to be reported and taxed on their individual returns. The corporation does not pay Federal or State tax, but does pay a State Franchise Tax (fee) annually.

Whether a Sub S corporation would be the organization type for you or not depends upon several factors, one of which is why are you considering incorporating? Generally, people form Sub S corporations for one of two reasons: to limit personal liability for business debts or to lower the amount of taxes that they are paying. Unless either of these is substantial, then a Sub S corporation is probably not going to benefit you.

There are costs associated with forming and operating a Sub S corporation. If you choose to have an attorney assist in the forming of the corporation, their fees can range from \$1,000 to \$2,000 or more. There are no corporate income taxes, but the corporation, in California, will pay an annual “franchise” tax of \$800. In addition to these costs, if you have the corporate tax returns professionally prepared, the cost could be from \$300 to \$600 or more annually.

One of the provisions of Sub S corporations is that the shareholders must receive reasonable compensation in the form of salary. What is reasonable salary is open to debate, as there are no set factors to determine what is reasonable. The net income that the corporation generates above the reasonable compensation is distributed to the shareholders, subject to income tax at their individual rates on their returns.

You should consult your tax professional and/or an attorney to determine whether an S Corp is how you want to structure your business.