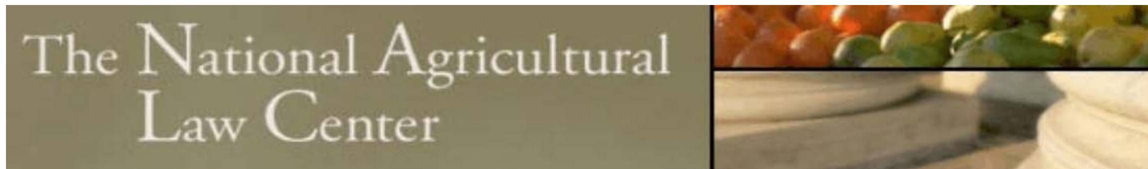

Business Organizations Reading Room

S Corporations

Rusty Rumley
Staff Attorney

Introduction

In the twentieth century, a revised corporate business structure began to gain recognition. Essentially similar to the traditional corporation, and known as an "S" corporation, this business form provides the same limited liability of a C-Corp, but allows the corporation's shareholders to elect against double taxation and choose instead to use "flow-through" taxation, where the profits are only taxed on the individual level. The structure itself is remarkably similar to the C-Corp. (indeed it is a C-Corp for most practical purposes) but it has a few important differences in the formation and the tax structure.

Formation

An S-Corp has the same initial formation requirements as a C-Corp, but demands additional requirements in order to qualify for the special tax treatment. There are two routes states have taken in allowing S-Corps to form. The first route, taken by the majority of states, allows the corporate organizers to create a traditional C-Corp, other states, however, offer a form of "closed" corporations with limitations on the number of shareholders and transferability of stock among them. In either case the newly formed corporation then has the opportunity to elect to be treated as an S-Corp by the Internal Revenue Service.

The person creating the S-Corp must file articles of incorporation with the state that includes all of the information needed to create a traditional corporation. The agency in charge of registering and creating new businesses varies from state to state and a list of these agencies and their contact information may be found at the National Agricultural Law Center under Forms and Filing Information: Business Organizations.

In order for a business to be treated as a S-Corp it must not only meet the requirements of a traditional corporation, but it must also meet several other requirements that are stipulated by the Internal Revenue Service. The business entity must be a domestic corporation or limited liability company with only one class of stock. C-Corps, on the other hand, can be formed anywhere and have multiple classes of stock- all of which may allow for different voting rights or dividend payments. The corporation that wishes to elect S-Corp status may not have more than 100 shareholders all of which must be U.S. citizens or residents. In other words, other partnerships

and corporations may not be shareholders. Profits and losses must be allocated to shareholders proportionately to each one's interest in the business, which is logical because there is only one class of stock available to shareholders. If these requirements are met, the corporation may file Form 2553 "Election by a Small Business Corporation" with the IRS to elect flow-through taxation status.

Liability

The liability issues for the S-Corp are identical to the traditional C-Corp. The protection provided by a corporation is often called a "veil" or "curtain" as it works to separate the debts and actions of the corporation from the stockholders and officers. Once established, corporations must follow "corporate formalities." These formalities are requirements that a corporation must follow in order to show that the corporation is a legitimate business that operates separately from its shareholders. Examples of formalities that should be followed are periodic meetings of the board of directors, record retention and separate bank accounts for the corporation, as well as numerous other approaches that serve to differentiate the corporation from its officers and shareholders. The protections that a court will recognize are contingent on the complete separation of the corporation and the owners. The more places where the corporation and its shareholders and officers are intertwined, the more likely a court will rule that the corporation is indistinguishable from its owners. If the corporation is found to be indistinguishable from its owners than the court may order that the corporation be disregarded and that the owners and shareholders assume personal liability for the actions and debts of the corporation.

Tax Structure

The primary difference between a C-Corp and a corporation that meets the additional requirements set forth by the IRS for S-Corp status is the tax structure. To qualify for this special tax treatment a corporation must place some small limitations on the corporation. In return for placing these limitations, they avoid "double taxation," the taxation at both the corporate and personal level, which remains one of the strongest detriments to the formation of a traditional corporation. Corporations that can meet the IRS requirements are able to elect "pass through" status. "Pass through" taxation allows the income, losses, deductions, and credits to "pass through" the corporation without first being assigned to the corporate entity. Under this tax structure, the corporation may be taxed like any partnership or sole proprietorship. The main limitation that faces corporations that elect for S-Corp status is the restriction to one class of stock. This limitation can prevent the optimal allocation of income, deductions, and credits among the shareholders, since they are divided evenly according to each shareholder's proportionate interest. Regardless, the "pass through" status of the S-Corp is a substantial advantage and for many small corporations throughout the United States the few restrictions that the IRS mandates are well worth complying with.

Termination

Because S-Corps are corporations that qualify for "pass through" taxation by the IRS the requirements for termination are the same as any traditional corporation. All fifty states have adopted some form of legislation that controls the formation, operation, and termination of a

corporation. Corporations differ from other business entities such as partnership and sole proprietorships in that the existence of the business is not dependent on the life or participation of any one individual. Some partnership structures can be modified to prevent the termination of a business entity at the loss of one or more partners; however the corporation is designed to continue on indefinitely. Larger corporations can continue on indefinitely due to the ease of transferring stock. Smaller corporations, especially "closed corporations", may have a more difficult time in transferring stock because of specific limitations on transfer that are often included in the operation's articles of incorporation. These restrictions on to whom and when stock may be sold have the potential to create a situation where a closely held corporation may be forced to terminate, however, this would happen rarely and with only very closely held corporations.

There are typically two ways for a corporation to terminate. The first, and by far the most likely means of termination, is accomplished by a vote of the shareholders. In this method, the state where the business was incorporated will have procedures or the corporation's articles of incorporation will set forth the amount of votes needed to terminate the corporation's existence. The other way that corporations may be terminated is by a judicial order. One way to obtain a judicial dissolution is if shareholders can show that the board of directors or the shareholders are unable to meet the dissolution requirement and that the shareholder interests are being devalued because of the inability to terminate the corporation. The shareholders can also apply for a judicial termination if they can show fraud or a waste of the corporation's business assets. Creditors of the corporation also have the right to file for a judicial dissolution in certain limited circumstances. A creditor would have to show that the corporation is unable to meet its financial responsibilities and that allowing the corporation to continue operating would only decrease the assets of the corporation.

Whether a corporation, C- or S-, is terminated by shareholder vote or by judicial dissolution the process itself is complex and time consuming. Many state statutes allow, after a shareholder vote for termination, for a period of up to five years in which the corporation can wrap up its business, sell assets, and distribute the capital back to shareholders.

Conclusion

Large national and multinational corporations often do not have the ability to meet the IRS requirements on applying for "pass through" tax status because of the limitations on the number of shareholders, the requirement of a single class of stock, and the restriction on who is able to be a shareholder. Smaller businesses that wish to have the protection provided by the corporate business structure while avoiding the problem of "double taxation" have the attractive alternative of electing for S Corp. treatment. There are requirements put in place by the IRS, but by their very nature the requirements are geared towards excluding the larger corporations from the "pass through" tax status. Although the S Corp. election is a relatively new option when compared to the traditional corporation, the popularity of the election has grown rapidly. This ability to avoid the "double taxation" trap has breathed new life into the corporate business structure and will allow it to compete with other new business entities like the limited liability company.