

Subchapters "S" Corporations

By J Fisher

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S CORPORATIONS AND "C" CORPORATIONS

S Corporations Explained

Generally people refer to two separate types of corporations, "C" corporations and "S" corporations. In reality, they are both the same type of entity under state laws governing corporate formation. Every S corporation starts out being a "C" corporation. To become an "S" corporation, a "C" corporation files an election with the Internal Revenue Service to be treated differently under tax laws.

WHAT IS THE PURPOSE FOR MAKING A SUBCHAPTER "S" ELECTION

If you file for Subchapter "S" status, you are electing to treat the corporation as a "pass-through" entity for income tax purposes. All of the implications of making this election are beyond the scope of this guide. However, generally speaking, if you make the election all of the profits and losses of the corporation will be passed onto the individual tax returns of the shareholders in proportion to their shareholdings. Generally speaking, the corporation will not be treated as a taxable entity.

HOW IS THE Subchapter S ELECTION MADE

A Subchapter "S" election is made by filing a properly completed IRS Form 2553 with the Internal Revenue Service. It is important that this election be made within the right time frame and that the election be properly completed. This is one area of forming your corporation where it pays to consult with your accountant.

BEWARE OF TIME LIMITS FOR MAKING Subchapter S ELECTION

There are time limits after formation when an election must be made with the IRS in order to receive the tax treatment of a Subchapter "S" corporation for the year that the corporation is formed. This decision does not have to be made immediately upon formation, but it cannot be delayed for too long if you want the immediate tax year advantages of Subchapter "S" Status.

CONSULT WITH YOUR ACCOUNTANT

Generally for true small businesses, Subchapter "S" status will be advantageous. However, the final decision should not be made without consulting with your accountant.

WHY CAN THIS BE AN ADVANTAGE

Again, speaking very generally, the reason this election is normally made is to avoid being taxed twice for the income of the corporation. Where the election is not made, the corporation will be a taxable entity and will pay tax on its net income at corporate income tax rates. When distributions are made to shareholders out of the net earnings, those shareholders will pay income tax again...thus resulting in taxation at both the corporate and individual levels. Although there are other ways of mitigating this tax effect which you should discuss with your accountant, making a Subchapter "S" election is the most common method used by most small businesses.

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