**S Corp Advantages and Disadvantages**

**Whether you are just starting your business, or have been operating as a sole proprietorship or general partnership, you may be wondering about the advantages of incorporating your business as an** [**S corporation**](http://www.bizfilings.com/s-corporation.aspx)**. Many business owners assume it will be too costly or time-consuming—but neither is the case.**

**What is an S corporation?**

An S corporation is a corporation that is treated, for federal tax purposes, as a pass-through entity through an election made with the Internal Revenue Service (IRS) to be considered an S Corporation. What does that mean?

As a corporation, an S corporation is created through filing Articles of Incorporation with the Secretary of State or similar government body. It issues stock and is governed as a corporation. The owners, who are called shareholders, have the same protection from liability as shareholders of a [C corporation](http://www.bizfilings.com/c-corporation.aspx). An S corporation shareholder’s **personal** assets, such as personal bank accounts, cannot be seized to satisfy **business** liabilities.

However, like a [sole proprietorship](http://www.bizfilings.com/sole-proprietorship.aspx) or a partnership, an S corporation passes through most of its income and loss items to the shareholders. Unlike a regular corporation, there is no "double taxation," once at the corporate level and again on the individual shareholder level. Each shareholder is subject to his or her own individual tax rate on the income (or losses) passed through to him or her.

**S corporation advantages**

The advantages of an S corporation often outweigh any perceived disadvantages. The S corporation structure can be especially beneficial when it comes time to transfer ownership or discontinue the business. These advantages are typically unavailable to sole proprietorships and general partnerships. S corporation advantages include:

* **Protected assets.** An S corporation protects the personal assets of its shareholders. Absent an express personal guarantee, a shareholder is not personally responsible for the business debts and liabilities of the corporation. Creditors cannot pursue the personal assets (house, bank accounts, etc.) of the shareholders to pay business debts. In a sole proprietorship or general partnership, owners and the business are legally considered the same—leaving personal assets vulnerable.
* **Pass-through taxation.** An S corporation does not pay federal taxes at the corporate level. (Most—but not all—states follow the federal rules. View the Ongoing Corporation Requirements page of our [state guides](http://www.bizfilings.com/states.aspx) to see if your state recognizes the federal S corporation election.) Any business income or loss is "passed through" to shareholders who report it on their personal income tax returns. This means that business losses can offset other income on the shareholders’ tax returns. This can be extremely helpful in the startup phase of a new business.
* **Tax-favorable characterization of income.** S corporation shareholders can be employees of the business and draw salaries as employees. They can also receive dividends from the corporation, as well as other distributions that are tax-free to the extent of their investment in the corporation. A **reasonable** characterization of distributions as salary or dividends can help the owner-operator reduce self-employment tax liability, while still generating business-expense and wages-paid deductions for the corporation.
* **Straightforward transfer of ownership.** Interests in an S corporation can be freely transferred without triggering adverse tax consequences. (In a partnership or an [LLC](http://www.bizfilings.com/limited-liability-company.aspx), the transfer of more than a 50-percent interest can trigger the termination of the entity.) The S corporation does not need to make adjustments to property basis or comply with complicated accounting rules when an ownership interest is transferred.
* **Heightened credibility.** Operating as an S corporation may help a new business establish credibility with potential customers, employees, vendors and partners because they see the owners have made a formal commitment to their business.

**S corporation disadvantages**

An S corporation may have some potential disadvantages, including:

* **Formation and ongoing expenses.** To operate as an S corporation, it is necessary to first incorporate the business by filing Articles of Incorporation with your desired state of incorporation, obtain a [registered agent](http://www.bizfilings.com/registered-agent.aspx) for your company, and pay the appropriate fees. Many states also impose ongoing fees, such as annual report and/or franchise tax fees. Although these fees usually are not expensive, and can be deducted as a cost of doing business, they are expenses that a sole proprietor or general partnership will not incur.
* **Tax qualification obligations.** Mistakes regarding the various election, consent, notification, stock ownership and filing requirements can accidentally result in the termination of S corporation status. Although this is relatively rare, and usually can be remedied easily, it is still an issue that is not a factor with other business forms.
* **Stock ownership restrictions.** An S corporation can have only one class of stock, although it can have both voting and non-voting shares. Therefore, there can’t be different classes of investors who are entitled to different dividends or distribution rights. Also, there cannot be more than 100 shareholders. Foreign ownership is prohibited, as is ownership by certain types of trusts and other entities.
* **Closer IRS scrutiny.** Because amounts distributed to a shareholder can be dividends or salary, the IRS scrutinizes payments to make sure the characterization conforms to reality. As a result, wages may be recharacterized as dividends, costing the corporation a deduction for compensation paid. Conversely, dividends may be recharacterized as wages, which subjects the corporation to employment tax liability.
* **Less flexibility in allocating income and loss.** Because of the one-class-of-stock restriction, an S corporation cannot easily allocate losses or income to specific shareholders. Allocation of income and loss is governed by stock ownership, unlike a partnership or LLC where the allocation can be set in the operating agreement. Also, the necessary accumulated adjustment account can be cumbersome to maintain, requiring input from an accounting professional.