

Small Business Clinic

*****This information sheet is intended to highlight certain rules and statutes relating to California S-corporations. It is not legal or professional advice, is not intended to be an exhaustive summary or comprehensive in nature and is not a substitute for personalized advice from a knowledgeable lawyer. Because this information is general in nature, it should not be relied upon as complete information regarding any of the matters discussed, but rather, should be used to complement a general understanding of the subject matter. (In addition, this information sheet does not attempt to include all required or associated filings, fees or costs and even the filings, fees and costs discussed are, of course, subject to change.) While we hope this information is helpful, we can undertake no responsibility to provide updates to this information. If you require legal assistance, please consult an attorney licensed to practice in your state.***

S-CORPORATION

Structure

- A corporation is considered a separate “person” under the law. A corporation is owned by its “shareholders.”
- Management.
 - The shareholders elect a “Board of Directors,” which consists of one or multiple “Board members.” The Board is responsible for making decisions on behalf of the corporation.
 - The Board of Directors appoints “officers” to manage the corporation. Each California corporation is required to have at least the following officers: President/CEO, Treasurer, and Secretary.
 - A California corporation must have three directors on the Board, unless the corporation is owned by fewer than three shareholders. In that case, the number of directors may be equal to or greater than the number of shareholders.
 - One person may serve as the sole shareholder, sole Board member, and as each of the President, Treasurer, and Secretary.
- The corporation’s shareholders contribute capital (or items with monetary value) to the corporation in exchange for shares of “stock,” representing ownership in the corporation. Stock typically entitles a shareholder to vote and to receive dividends.
- S-corporations are structurally the same as C-corporations (albeit S-corporations are limited to a relatively simple ownership structure). The election of S-



corporation status is a tax election, and thus the two entities are taxed differently.

Limited Liability

- A Corporation's shareholders have limited liability assuming that the necessary rules are followed. Such rules include:
 - assuring that the corporation is properly formed and organized (e.g., filing Articles of Incorporation, adopting Bylaws, conducting an organizational meeting, issuing stock and making any other required filings);
 - adequately capitalizing the corporation (-- making sure there is enough money in the corporation to operate the business properly);
 - following corporate formalities (e.g., conducting annual meetings of the shareholders and the directors, maintaining minutes, approving corporate actions); and
 - treating the corporation as a separate entity (e.g., not comingling business funds with personal funds, separating the corporation's business affairs from the shareholders' personal affairs, not paying personal bills from the corporation's bank account).
- If a third-party wants to hold the shareholders personally liable, the third-party must attempt to "pierce the veil."
 - The third-party must typically show:
 - (1) the corporation and shareholder(s) are not separate and
 - (2) injustice or fraud will occur if the veil is not pierced.

Dividends

- An S-corporation's shareholders typically receive distributions from the corporation in the form of "dividends."
- Dividends are paid to shareholders at the discretion of the Board and are distributed based on the stock ownership percentage of each shareholder.
- Shareholders do not pay tax on the distributions that they receive from the corporation due to "pass through taxation." Instead, the shareholders are responsible for the tax on the S-Corporation's profits. *See below*.
 - This is different from the way that shareholders of C-corporations are taxed when they receive dividends. Dividends in a C-corporation are subject to "double taxation."

Taxes

- In order to be taxed as an S-Corporation, the entity:
 - (1) must be organized under the laws of the U.S.;
 - (2) may have 100 shareholders at most, all of whom are individuals and are not non-resident aliens; and

- (3) can only have one class of ownership interest. (i.e.: only common stock)

Federal

- The corporation itself does not pay federal tax. Instead, the profits and losses “pass through” to the shareholders, and the shareholders are individually responsible for paying the tax liability on the corporation’s profits. Each shareholder includes his or her share of the profits (or losses) on his or her individual tax return.
 - This tax must be paid whether or not the profits are retained by the corporation or are distributed to the shareholders in the form of dividends.
 - An S-corporation may distribute to its shareholders the money necessary to pay the taxes, but that decision is at the discretion of the Board.
- Commencing in 2018, many owners of S-corporations (as well as LLCs, partnerships and sole proprietorships) may be able to deduct 20% of their “Qualified Business Income.” The deduction generally applies to taxpayers with taxable incomes under \$157,000 and married taxpayers filing joint returns with income under \$315,000. If a taxpayer’s income is over these thresholds, then the question of how and whether the deduction applies becomes very complicated and depends upon factors like whether the business is a specified type of “service business” and the amount of W-2 wages paid by the business. You need to consult a tax advisor about how the new tax law will apply to your business.
- Shareholders do not need to pay additional taxes on the money distributed to them (unlike how shareholders of C-corporations must pay tax on the dividends they receive).

State Taxes

- Each S-corporation that does business in California is subject to an annual state tax of 1.5% of its net income or \$800, whichever is greater.
 - The \$800 minimum is waived for the corporation’s first year taxable year; however the 1.5% is not. (For example, if the corporation’s income is \$20,000, the state tax will be \$300 (1.5% of \$20,000) for the first year.)

Filing Fees, Costs & Forms and Necessary Documents

- Articles of Incorporation. A corporation is formed by filing Articles of Incorporation with the Secretary of State.
 - \$100.00 (plus a \$15 over-the counter fee if the Articles are filed in person)
 - \$30 per amendment or restated Articles
 - There may be additional fees if a filing service is used (e.g., \$45)

- Action of Incorporator. Appoints the initial directors of the corporation and may adopt Bylaws.
 - No Cost – Internal Document
- Bylaws. Set forth the rules, procedures and structure for the operation of the corporation.
 - No Cost – Internal Document
- Action by Unanimous Written Consent/Minutes. Action of the Board that elects officers, may name directors, approves the sale of stock, and approves other elements in the organization of the corporation.
 - No Cost – Internal Document
- Statement of Information. Must be filed within 90 days of the LLC's organization and annually thereafter.
 - \$25.00 per filing
- Form 2553. IRS form to elect S-corporation status. Must be filed by the 15th day of the third month of the taxable year for which the corporation wants to be taxed as an S-corporation. (This means that if the corporation wants to be taxed as an S-corporation, this Form must be filed within 75 days of the corporation's formation.)
 - No Cost

When to form an S-corporation

S-corporations are typically formed when:

- There are few shareholders and no professional investors.
- The corporation will only be owned by individuals who will hold the same "class" of stock. (Sometimes shareholders will form an S-corporation in a corporation's initial phase and convert to a C-corporation when professional investors become involved.)
- The shareholders play similar roles in the business (e.g., each shareholder has contributed a proportionate amount of the capital and provides a proportionate amount of the labor).
- Shareholders are also board members and officers.
- Shareholders want to avoid double taxation.
- The business is not planning on reinvesting the bulk of its profits into the business.