B. JOFFRION CONSULTING, LLC
BUSINESS STRUCTURING & TAX COUNSEL

Should Your Company Elect S Corporation Status?

The S election can save real money. It can also cost more than it saves, and it comes with rules that punish the casual.

Somebody told you that you should be an S corp. Maybe your bookkeeper, maybe a podcast, maybe a friend who says it saved him thousands. Sometimes they are right. The savings are real for an owner who works in a profitable business and is willing to run payroll and keep the paperwork straight.

The election is also a commitment. It brings its own return, its own payroll obligations, eligibility rules that can be broken by accident, and state taxes that vary widely. This guide covers what the election does, who can make it, what it costs, and how it goes wrong.

What the Election Does

An S corporation is not a type of company. It is a tax status. A corporation, or an LLC that elects to be taxed as a corporation, files Form 2553 and asks to be taxed under Subchapter S of the Internal Revenue Code.

- **It passes through.** The company generally pays no federal income tax. Its income, deductions, and credits flow to the shareholders on Schedule K-1, and the shareholders pay tax on their shares whether or not the money is distributed.
- **Owner-employees go on payroll.** A shareholder who works in the business must be paid reasonable compensation as wages, with withholding and employment taxes, before taking distributions.
- **The savings come from distributions.** Profit above that salary can come out as a distribution, which is not subject to Social Security and Medicare tax. In a sole proprietorship or an LLC taxed as a partnership, the owner's whole share of business profit is generally subject to self-employment tax. That difference is the entire point of the election.

Put plainly: a sole proprietor pays self-employment tax on all of the profit. An S corporation owner pays employment tax only on the salary. If the profit barely exceeds a reasonable salary, there is little left to save.

Who Is Eligible

The company must meet every test on the day of the election and every day after. Fail one, and the election terminates.

- **Domestic.** It must be a U.S. corporation or an LLC eligible to elect corporate taxation.
- **No more than 100 shareholders.** Spouses, and members of a family as the tax code

defines it, can count as one.
- **Eligible shareholders only.** Individuals, estates, certain trusts, and certain tax-exempt organizations. Partnerships, corporations, multi-member LLCs taxed as partnerships, and nonresident aliens cannot own shares. A single-member LLC disregarded for tax purposes can hold the shares if its owner is eligible.
- **One class of stock.** Every share must carry identical rights to distributions and to proceeds on liquidation. Differences in voting rights alone are allowed.

The one-class rule is where LLCs get into trouble. The IRS looks at the company's governing provisions: its articles, bylaws, operating agreement, and binding agreements about distributions. If those documents give one owner a preferred return, a larger share of profit than ownership, or partnership-style capital account and liquidation provisions, the company may have a second class of stock and no valid election. An LLC operating agreement written for partnership taxation often contains exactly those provisions, and nobody revises it when the election is filed.

Distributions that simply come out unequal in practice, while the governing documents require them to be proportionate, generally do not create a second class of stock. The IRS confirmed that position in Rev. Proc. 2022-19. They still need to be corrected, and a pattern of them invites the argument that the real agreement differs from the written one. The safe practice: distribute strictly by ownership, and if one owner takes extra, true it up promptly.

Making the Election

Form 2553 must be filed no more than 2 months and 15 days after the beginning of the tax year the election is to take effect, or at any time during the preceding tax year. For a calendar-year company, that is generally March 15. For a new company, the clock starts on the day its first tax year begins, usually the date it was formed or began business, not January 1. Every shareholder must sign a consent.

LLCs do not need to convert. An eligible LLC that files a timely Form 2553 is treated as having elected to be taxed as a corporation, and it does not have to file Form 8832 separately. It remains an LLC under state law, with the same operating agreement and liability protection, and is taxed as an S corporation.

Missed the deadline? A late election generally takes effect the following year. Rev. Proc. 2013-30 offers relief without a private letter ruling if the company intended to be an S corporation, failed to qualify solely because the election was late, has reasonable cause, and it and all its shareholders have reported consistently with S status. The request generally must be made within 3 years and 75 days of the intended effective date, and the form is marked "FILED PURSUANT TO REV. PROC. 2013-30." Outside that relief, the remedy is a private letter ruling, which carries a substantial IRS user fee.

Keep the IRS acceptance letter. Banks, lenders, and future buyers will ask for it, and the IRS cannot always produce it quickly.

The Costs That Eat the Savings

- **Payroll.** A payroll service, quarterly payroll returns, W-2s, and state unemployment and withholding registrations. Most small companies pay for a service, and the fees run every month.
- **Payroll taxes on the salary.** The company pays the employer half of Social Security and Medicare and federal and state unemployment tax. The election reduces employment tax; it does not eliminate it.
- **A separate return.** Form 1120-S, plus K-1s, plus any state return. Preparation usually costs more than a Schedule C.
- **State treatment.** States do not all follow the federal election. A few jurisdictions, including the District of Columbia, New Hampshire, Tennessee, and New York City, tax the company at the entity level as though the election did not exist. Others impose their own tax on S corporations. California taxes an S corporation's California net income at 1.5%, with an $800 annual minimum franchise tax (waived for a new corporation's first taxable year, though the 1.5% still applies to first-year income). Check every state where the company does business, not only where it was formed.
- **Lost flexibility.** Partnership taxation allows special allocations, tax-free distributions of property, and basis adjustments when ownership changes. S corporation taxation allows none of these, and taking appreciated property out of an S corporation is generally a taxable event.

Run the numbers with those costs included. An owner netting modest profit can spend more on payroll, return preparation, and state tax than the election saves.

Reasonable Compensation

This is the risk the election is built around. The IRS expects a shareholder who provides services to be paid wages that reflect the value of those services before taking distributions. If the salary is too low, or zero, the IRS can recharacterize distributions as wages and assess the employment taxes, penalties, and interest.

No formula exists. The factors the IRS and the courts look at include the owner's training and experience, duties and time spent, what comparable businesses pay for comparable services, the company's dividend history, and what the owner would have to pay someone else to do the job. A defensible salary has a basis you can show: salary survey data, a written compensation study, or a board consent that recites how the number was set.

Set it at the start of the year, put it in a consent, and revisit it when the business changes. A salary chosen in December to make the distributions look right is a salary chosen to minimize tax, and it reads that way.

Salary and Distribution Mistakes

- **Taking draws instead of running payroll.** Transfers from the company account to yours are distributions unless they go through payroll. Twelve months of draws and no W-2 is the classic audit pattern.
- **Distributing out of proportion.** See the one-class rule above. Distribute by ownership

percentage, every time.

- **Distributing more than basis.** Distributions beyond a shareholder's stock basis are generally taxable as gain. Track basis every year.
- **Paying personal expenses from the company account.** Those are distributions too, and often disproportionate ones.
- **Leaving health insurance off the W-2.** Health insurance the company pays for a shareholder owning more than 2% generally belongs in that shareholder's wages. Getting it wrong can cost the shareholder the self-employed health insurance deduction.

Trusts as Shareholders

Owners who hold their companies through trusts for estate planning need to know which trusts qualify. A trust that is not eligible ends the election the day it receives shares.

- **Grantor trusts,** including most revocable living trusts, qualify while the grantor is alive, because the grantor is treated as the owner for tax purposes. After the grantor's death, the trust can generally continue to hold the shares for two years.
- **Qualified subchapter S trusts (QSSTs)** have one current income beneficiary and must distribute all income to that beneficiary. The beneficiary makes the election, and it has its own deadline.
- **Electing small business trusts (ESBTs)** can have multiple beneficiaries and can accumulate income, but the trust pays tax on its share of S corporation income at the highest individual rate. The trustee makes the election.

Coordinate the trust document with the election before shares move, and calendar the QSST or ESBT election deadline the day the transfer happens.

Getting Out

The election stays in effect until it is revoked or terminated. Shareholders holding more than half the shares can revoke it by filing a statement with the IRS. A revocation filed within the first 2 months and 15 days of a tax year can take effect that year; otherwise it takes effect the next year unless a later date is specified. The election also terminates automatically when the company stops qualifying, for example when an ineligible shareholder acquires shares.

Either way, the company generally cannot elect S status again until the fifth tax year after the termination or revocation took effect, without IRS consent. An LLC that revokes its S election does not automatically return to partnership or disregarded status; it remains taxed as a C corporation unless it takes further steps, and changing that classification can itself be a taxable event. Treat the election as a multiyear decision.

Related reading at bjoffrionconsult.com/blog: "What does an S-corp election actually commit you to?" and "What 'reasonable compensation' actually means for an S-corp owner."

If You Want This Answered for Your Company

Entity Tax Classification Analysis — from $850. A written analysis of whether the S election

makes sense for your company: the projected savings against payroll, return, and state costs, eligibility issues in your ownership and governing documents, and what has to change before you file.

Structuring Consultation — $200. A focused consultation on your entity, its ownership, and its tax classification, and what to do next.

The fee for a consultation is credited in full toward any written work you commission within 30 days.

Full service list and current pricing: www.bjoffrionconsult.com/services

1500 N Grant St Ste N, Denver, CO 80203 · brandi@bjoffrionconsult.com · www.bjoffrionconsult.com
General information only, not legal or tax advice for your situation. Brandi L. Joffrion is licensed to practice law in Colorado. Receiving this guide does not create an attorney-client relationship.
© 2026 B. Joffrion Consulting, LLC