



FARM COMMONS

# Farmer's Guide to S Corporations

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**AT A GLANCE: S CORPORATION FEDERAL TAX STATUS**

| General Concept   | LLC with S Corp Tax Status  | C Corporation with S Corp Tax Status  |
|---|---|---------------------------------------|
| Name  | "Farm Name, LLC"  | "Farm Name, Inc."                     |
| Owners / Investors are called:                              | "Members"   | "Shareholders"                        |
| Persons who make management decisions are called:           | "Managers" (if manager-managed); "members" (if member-managed)  | "Officers"                            |
| Creation document is called:                                | "Articles of Organization"  | "Articles of Incorporation"           |
| Organizing Document is called:                              | "Operating Agreement"   | "Bylaws"                              |
| An owner's investment in the company is called:             | "Capital Contribution"  | "Equity Investment"                   |
| An ownership share is called:                               | "Percentage Interest"   | "Shareholder Equity" or "Shares"      |
| A payment of the company's profits to the owners is called: | "Distribution"  | "Dividend"                            |
| Is there Personal Liability?                                | Limited to a member's capital contribution  | Limited to a shareholder's investment |
| General Concept   | S Corporation Specific  |                                       |
| How many participants can you have?                         | Maximum 100 persons; all must be U.S. citizens and all must be human beings, estates, tax exempt entities or certain qualified trusts                     |                                       |
| Annual meeting required?                                    | Required  |                                       |
| Different Owner Classes allowed?                            | Not allowed   |                                       |
| EIN necessary?  | Required  |                                       |
| Taxation basics   | Pass-through; but, entity must file informational Form 1120S with the IRS, distribute schedule K-1 to each owner, and file all schedule K-1s with the IRS |                                       |

Farm Commons strongly recommends that farmers read the chapters on LLCs and C Corporations before proceeding with S Corporations. These chapters can be found in the full “Farmer’s Guide to Choosing a Business Entity” or as individual resources, all available for download at [FarmCommons.org](http://FarmCommons.org).

“An S corporation is a federal tax status that is recognized by the IRS. Before becoming an S corporation you will first need to create an entity in your state.”

## Introduction

An S corporation is a federal tax status that is recognized by the IRS. It is not a state-created entity such as a corporation or an LLC. Before becoming an S corporation (or, rather, electing S corporation tax status) you will first need to create an entity in your state. If you decide you want to elect S corporation tax status, the entity options for your farm operation are pretty much limited to either an LLC or a C corporation. Be sure to read chapter 2 on LLCs and chapter 3 on C corporations (part 2, chapters 2 and 3 in the *Farmers Guide to Choosing a Business Entity*) to help you determine which is the best option for your farm business. Once you’ve created your entity—by filing your articles of organization (LLC) or your articles of incorporation (C corporation) with your state’s Secretary of State office (or whichever state agency handles business creation documents)—you’ll then need to consider whether electing S corporation tax status with the IRS is ideal for you.

This chapter covers the characteristics, tax benefits, and various requirements of the S corporation tax status. It also provides a basic overview of certain tax procedures S corporations need to follow. The purpose of this chapter is to provide farmers with a basic understanding of what it means to run a farm operation as an S corporation. S corporations are deeply rooted in tax issues, and therefore the financial implications will vary depending on the specific financial situations of the owners as well as the farm operation itself. While this guide is not intended to provide tax advice, it will provide a brief overview of tax issues that go along with S corporations. Farm Commons strongly recommends farmers to see an accountant or tax attorney for guidance in deciding whether the S corporation tax designation is best for their farm operation before electing S corporation status.

## S Corporation Origins

Congress created the S corporation in the late 1950’s as a way to help small and family-owned businesses. The “S” actually stands for “small” business corporation. Before Congress created the S corporation, small business owners had only two choices when starting a business. They could create a traditional corporation (referred to here as a C corporation) or they could just accept the default structure of a sole proprietorship if one owner or general partnership if multiple owners. It was really a decision on the lesser of two evils: double taxation or no liability protection.

While the C corporation provides a level of protection on business owners’ personal assets, it is at the expense of what is known as “double taxation.” Here’s

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how it works. A C corporation first pays corporate tax on the business' taxable income, should there be any at the end of the company's fiscal year. Then, if the company passes profit back to the owners, the shareholders must pay taxes on any earnings or profits they receive from the company. Granted, the individual owners are taxed at the dividend tax rate, which is currently less than the tax rate for ordinary income. But in the case of a small business where the owners depend on dividends for a portion of their household income, the total taxes paid on business income for the small business and owners can be astronomically high. On the other hand, while the partnership or sole proprietorship allows owners to avoid taxation at the business income level, the owners have to sacrifice protection of their personal assets for business liabilities. The S corporation was created to solve this quandary faced by small business owners.

Ultimately, the S corporation serves as an incentive for small business owners to form a business entity by stripping away the corporate tax burden. With the S corporation tax status, the owners' personal assets are protected from business liabilities and they don't have to pay double taxes on the business' income. Instead, the entity's income is passed through to the owners, and the owners report the business income and pay the required taxes when filing their individual tax returns. So, federal tax is treated just like the sole proprietorship, general partnership, and LLC. This explains why the S corporation has become so popular amongst small farm owners!

#### **Growing popularity of the LLC with S corporation tax status combination**

The IRS estimates that there were over 4.6 million S corporation owners in the U.S. in 2014, which is over twice the number of C corporations. The number of LLCs has grown rapidly, rising from fewer than 120,000 in 1995 to more than a million today. The IRS clarified its rules for LLCs in the late 1990's, allowing LLC's to elect the C corporation or S corporation tax status or to simply be taxed as a sole proprietorship or general partnership. Ever since, the LLC has been gaining traction and is now one of the most popular entity choices for small businesses throughout the country given both its flexibility and liability protection. For a more detailed discussion on the LLC's flexibility and personal liability protection, read the chapter on LLC's in the full guide, *Farmer's Guide to Choosing A Business Entity*.

## Basic Characteristics of the S Corporation

### The S corporation protects personal assets from business liabilities

To get S corporation tax status, an entity must first be created at the state level as an LLC or C corporation. Given this, the S corporation comes with the same level of protection over personal assets that is provided by that business entity. To preserve the liability protection of personal assets, be sure to read chapter 2 on LLCs and chapter 3 on C corporations (part 2, chapters 2 and 3 in the *Farmer's Guide to Choosing a Business Entity*) or review the refresher in the box below.

In short, this personal liability protection is limited to the amount that each owner has invested in the company. In other words, once an owner transfers his or her investment in the farm operation to the business entity (i.e. a capital contribution if an LLC or an equity investment if a C corporation), the investment is the property of the entity. The owner is not entitled to get the investment back, and thus, she risks losing it. In effect, this investment amount reflects each owner's stake in the farm business. There are also certain caveats to the protection of personal assets that LLCs and C corporations offer. If the farm owners do not follow certain standards, the courts can reach around the personal liability protection and allow creditors to access the individual owners' personal assets. There are two basic ways to prevent this. First, the farm business needs to be adequately capitalized so that the company can make due on its debts. Second, the owners must keep their personal affairs separate from business affairs by keeping separate bank accounts and not commingling funds.

Keep in mind, forming a business entity and electing S corporation tax status is not a substitute for insurance. It does nothing to change the landscape of a farm's potential liability. It only limits the assets available to satisfy that liability, should it materialize, to business assets. All the farm's assets are entirely available to anyone with a successful claim against a farm business entity. Good liability insurance provides the farm with a defense in court and a source of funds to pay out on a court claim if it is successful. Farm Commons strongly urges any farm business, no matter what business entity it adopts, to maintain adequate insurance coverage.

In business law jargon, people often refer to the entity's protection of the owners' personal liability as a "shield" and the process of eliminating that protection if the owners don't run the business properly as "piercing the veil."

“Forming a business entity and electing S corporation tax status is not a substitute for insurance. It does nothing to change the landscape of a farm's potential liability.”

#### Refresher on protecting personal assets from business liabilities

Basically, there are two essential ways to protect business owners' personal assets: (1) sufficiently capitalize the farm operation and (2) keep the farm operation's affairs separate from the owners' personal affairs. First, business

owners may lose their personal liability protection if the company is undercapitalized. As a basic rule of thumb, a company is adequately capitalized if it can make due on its debts, i.e., pay its monthly bills. Anything less would be undercapitalized. Courts are also able to access personal assets if the members fail to keep the business separate from their personal affairs. This includes commingling funds such as drawing on business assets to pay for personal expenses or not keeping separate business and individual bank accounts. The takeaway here is to develop policies and systems for keeping the farm business and individual affairs separate which include at the minimum having separate bank accounts, credit cards, and accounting systems.

Even if an entity is properly maintained, creditors often require that individual owners of a business entity personally guarantee obligations. Creditors know that if there's nothing left in the business entity there will be nothing left for them. What this means is that creditors may require a business owner to commit to loan payments as an individual, not just as a business owner (i.e. member of an LLC or shareholder of a corporation). As a result, personal assets will be on the line even though the business owner took on the obligation to benefit the business. Business owners have to negotiate whether and to what extent a personal guarantee is required is with creditors on a case by case basis.

“The primary tax benefit of the S corporation is the single layer of taxation, also referred to as pass-through taxation.”

## **S corporations receive special tax benefits**

### **Single layer of taxation**

Farm operations often prefer the S corporation tax status because of its special tax benefits. As already mentioned, the primary tax benefit of the S corporation is the single layer of taxation, also referred to as pass-through taxation. Indeed, pass-through taxation is the default tax status of the LLC, sole proprietorship, and general partnership (a single member LLC is taxed as a sole proprietorship and multi-member LLC is taxed as a general partnership, unless elected otherwise). So this tax benefit is really only relevant for farm operations that are C corporations. Pass-through taxation allows the business' income to pass through to the owners without requiring the entity to first pay corporate taxes on business profits. The S corporation tax status allows a standard C corporation to be taxed this way. In effect, the owners can circumvent the double taxation dilemma of the C corporation. If an entity obtains S corporation tax status, the entity does not have

“The IRS handles self-employment taxes slightly differently for entities with the S corporation tax status.”

Distributions or dividends can of course only be made if there are sufficient profits in the farm operation. Otherwise, the entity will be considered undercapitalized.

“If you elect S corporation tax status for your business entity, keep in mind that the IRS does not look fondly on artificially low salaries and can reclassify dividends as salary.”

to pay federal taxes on business income. Instead, each of the owners reports the business' income on his or her individual tax return and pays taxes on it.

#### State taxes are not addressed in this guide

The S corporation tax status is only relevant for federal income taxes filed with the IRS. The farm entity will still need to abide by the state tax requirements. State taxes are separate and not addressed in this resource.

#### Potential self-employment tax savings

The other special tax benefit that the S corporation provides relates to self-employment income. The IRS handles self-employment taxes slightly differently for entities with the S corporation tax status. Basically, in addition to a “reasonable” salary that the farm business pays can pay the owners, the farm business can hand out business profits in the form of “distributions.” Distributions are taxed at the lower dividend tax rate. In addition, distributions are free from self-employment taxes including Social Security and Medicare taxation, which can equate to about 15% savings in federal taxes. The take away here is that if a farm operation is an LLC or a C corporation and it is expected to earn significant revenues that are above and beyond a “reasonable salary” for the owner(s), the S corporation tax status may be a good option.

You may be thinking, well, this is great, I can just keep my salary as low as possible so that the remainder is taxed at the lower dividend tax rate. Be careful! If you elect S corporation tax status for your business entity, keep in mind that the IRS does not look fondly on artificially low salaries and can reclassify dividends as salary. If this happens, the individual owner will end up having to pay back taxes and may risk an audit. So it's best to declare a “reasonable salary.” So, what's a “reasonable” salary? The IRS will look at many different factors in making this determination. Anything above a reasonable salary could be reclassified and taxed at the higher employment income rate. The IRS will consider many factors including the following:

- training and experience of the individual,
- duties and responsibilities of the individual,
- time and effort devoted to the business by the individual,
- dividend history of the business,
- payments to non-shareholder employees,



“A farmer with extensive experience who devotes great effort to the business may be less able to justify a low salary.”

- timing and manner of paying bonuses to key people,
- what comparable businesses pay for similar services,
- compensation agreements, and
- the use of a formula to determine compensation.

So what then is a “reasonable salary” for farmers or farm owners? It will depend on all the above factors and may, in fact, vary based on the region. A farmer with extensive experience who devotes great effort to the business may be less able to justify a low salary. If a farm business pays other employees well, and managers of similarly sized non-farm businesses receive ample salaries, the farm owner may have a hard time justifying a tiny salary as “reasonable.” Current national statistics on farming itself can also help pinpoint a reasonable salary. According to the Bureau of Labor Statistics, in 2014, the average annual income for supervisors of farms and farmworkers is \$47,540. If you own and run your own farm operation, which includes supervisory duties, the IRS may consider this as the baseline. Let’s say an owner of a company with net annual income of \$50,000 tried to claim that just \$20,000 of that was a reasonable salary in hopes of getting a tax break on the remaining \$30,000. You might have an uphill battle convincing the IRS that a farmer of similar skill and responsibilities could only reasonably expect \$20,000.

### How the S corporation tax status differs from the standard LLC and C corporation

The S corporation sounds a lot like the LLC. The LLC provides pass-through taxation and protects personal assets from business liabilities. So does the S corporation! So what’s so different about the standard LLC and an S corporation (keeping in mind that an S corporation is really an LLC or C corporation with S corporation tax status)? In short, the S corporation provides some potential tax benefits related to self-employment taxes. However, to get that benefit, the entity has to meet specific criteria and follow certain formalities, including holding annual meetings and dealing with federal tax paperwork every year. This is above and beyond what a traditional LLC requires.

So what’s the difference between an S corporation and a C corporation? Well, the S corporation has an inflexible structure and requires certain formalities like the standard C corporation. However, unlike the C corporation, the S corporation provides the pass-through taxation to circumvent the double

taxation dilemma. The S corporation does not have to pay corporate taxes on business income. Instead, business income passes through to the individual owners who must report business income and pay their share of taxes on their individual tax returns. In addition, with an S corporation, business owners get to take advantage of the potential savings on self-employment taxes, which aren't available with a traditional C corporation.

Continue reading this chapter on S corporations for more details on the tax benefits, requirements, and formalities that come with an S corporation. Then you can decide whether the benefits outweigh the costs for your farm operation.

#### BASIC COMPARISON OF THE BENEFITS OF A FARM'S BUSINESS STRUCTURE CHOICES

|  | Protection of Personal Assets | Pass-Through Taxation | Potential Self-Employment Tax Savings |
|--|-------------------------------|-----------------------|---------------------------------------|
| Sole Proprietorship / General Partnership                              |                               | ✓                     |                                       |
| LLC (with default filing as a sole proprietorship/general partnership) | ✓                             | ✓                     |                                       |
| C Corporation  | ✓                             |                       |                                       |
| S Corporation  | ✓                             | ✓                     | ✓                                     |

## Criteria and Formalities Required for S Corporation Tax Status

“To be eligible for S corporation tax status and receive the special tax benefits, the farm business will need to meet four basic criteria.”

To be eligible for S corporation tax status and receive the special tax benefits, the farm business will need to meet certain criteria and follow some formalities.

Four basic criteria must be met. If all four are not met, the farm business will not be eligible for S corporation tax status. First, the entity receiving the S corporation tax status has to have been filed in the United States. In other words, it can't be a foreign company. Second, all owners of the entity, whether members or shareholders, have to be U.S. citizens. So, if one of the farm business owners is from Canada and has not received citizenship, then it cannot elect S corporation tax status. Third, the IRS does not allow another for-profit entity such as an LLC or corporation to be an owner of an S corporation. All owners must be living and breathing human beings, estates, tax-exempt entities, or certain qualified trusts.

Finally, the farm operation must have 100 or fewer owners. So, a single member LLC can elect S corporation tax status, but if the farm operation has more than 100 members or shareholders it cannot elect S corporation tax status.

**The criteria: is your farm business eligible for S corporation tax status?**

1. If you answer yes to all of the four following questions, your farm entity is eligible for S corporation tax status:
2. Was your farm operation entity created in one of the 50 U.S. states?
3. Are all the owners U.S. citizens?
4. Are all of the owners human beings, estates, tax-exempt entities, or certain qualified trusts?
5. Do you have 100 or fewer owners (family members count as just one shareholder for this purpose)?

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“The farm business will also need to hold annual meetings and prepare certain tax forms.”  
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The farm business will also need to abide by certain formalities to obtain and maintain the S corporation tax status. This includes holding annual meetings and taking minutes to evidence what happened in each meeting. Also, certain tax forms must be distributed to all of the business owners and these forms must be filed alongside a thorough informational tax form with the IRS every year. While similar formalities and requirements are required for a C corporation, they are above and beyond what is required for a typical LLC. More details about these formalities and tax paperwork requirements will be discussed next. Be sure you meet all four criteria and carefully consider the required formalities before deciding to elect S corporation tax status.

## Electing S Corporation Tax Status

So if you’ve decided to pursue S corporation tax status, you’ll likely be asking this next: what all do you need to do to be recognized as an S corporation? It’s really quite simple. First, if the farm business is an LLC, you’ll first need to fill out and file the IRS form 8832, “Entity Classification Election.” Here, you’ll elect your preference to be taxed as a corporation. Don’t stop there! Once you do this, you will be taxed as a C corporation and unless you follow the next step, you’ll face the double taxation dilemma. If you’re an LLC that’s filed IRS form 8832 or you are a C corporation that wants to receive the S corporation tax status, you will need to fill out and file with

the IRS tax form 2553 “Election by a Small Business Corporation.” The form should be completed up to two months and fifteen days after the beginning of the tax year the election is going to take effect, or at any time during the tax year preceding the tax year it is to take effect. This sounds complicated but the IRS provides examples of how the timing works in the instruction sheet for form 2553. Ideally, you will file these forms within twelve months of forming your business entity. However, if you don’t, you can still go through a process for a late classification.

#### How to elect S corporation tax status

**If you have an LLC:** First file IRS tax form 8832 to elect your preference “to be classified as an association taxable as a corporation” and then file IRS tax form 2553 to be classified as an S corporation.

**If you have a C corporation:** File IRS tax form 2553 to be classified as an S corporation. These forms are available to download on the IRS website.

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Farm Common highly recommends that farmers consult with a tax attorney or accountant *before* filing these tax forms to be sure the S corporation tax status is the best option and the appropriate procedure is followed. Once the election is made, be sure to follow through by upholding good business practices, including following the required formalities and filing and distributing the required tax forms every year. Learn more in the next section.

## Implementing Good Business Practices to Maintain S Corporation Tax Status

To continue to reap the benefits of the S corporation tax status and to maintain the liability protection provided by your selected business entity (i.e. LLC or corporation), the farm operation must follow through by upholding good business practices. For more detailed guidelines on this, be sure to read the LLC or C corporation chapters in Farmer’s Guide to Choosing a Business Entity. Basically, you must keep your business affairs separate from your personal affairs, abide by the provisions of your organizing document (the operating agreement if an LLC or bylaws if a corporation), file applicable annual maintenance fees with the state, and maintain accurate accounting records. Here, we’ll cover formalities that are specific to the S corporation. These include holding annual meetings and distributing and filing the required IRS tax forms.

See the *sample annual members meeting minutes* (for LLCs) and the *sample annual shareholder meeting minutes* (for C corporations) in the going deeper sections of the chapters on LLCs and C corporations, which can be found within the larger resource “Farmer’s Guide to Choosing A Business Entity,” available at [FarmCommons.org](http://FarmCommons.org).

“Once you elect S corporation tax status, be sure the entity and each of its members fulfills annual tax obligations.”

Don’t forget to file and pay your state income taxes!

## Hold annual meetings

The IRS requires that an S corporation hold an annual meeting. You must have provisions setting forth the parameters for your annual meeting in your organizing document (the operating agreement if an LLC or bylaws if a corporation). The provision generally includes the month or season when the annual meeting is to happen. It also includes requirements for when and how you will notify the business owners about the place, time, and other relevant details about the meeting such as matters to be discussed. Once you set these parameters, you must follow them. You need to also take minutes to record what happens at the meetings. The minutes don’t have to be elaborate, just enough to provide evidence of what happened and help the participants recall what was discussed and decided if needed.

## Distribute and file S corporation tax forms: Form 1120S and Schedule K1

Once you elect S corporation tax status, be sure the entity and each of its members fulfills annual tax obligations. This includes distributing tax forms, filing tax forms, and, of course, making sure the individual owners pay taxes when due.

As an S corporation, you’ll have to file the annual form 1120S with the IRS. This is not a tax return, as the entity does not have to pay income taxes itself. Rather, this is an informational tax document used to report the business entity’s profits, losses, and any disbursements of profits given to its owners (dividends to shareholders if a corporation or distributions to members if an LLC). Again, the entity itself will not have to pay taxes, as the business’ income passes through to the individual owners.

In addition, you will have to provide each of the owners with a Schedule K-1. The Schedule K-1 is similar to a W-2, the end-of-the-year wage statement that employees receive from their employers. The Schedule K-1 shows the self-employment income that each of the owners receives from the company. The entity must also submit a copy of Schedule K-1 to the IRS for each business owner. This allows the IRS to be sure that each owner is properly reporting any self-employment income he or she receives from the entity that has S corporation tax status.

Farm Commons recommends that you seek expert tax guidance before filing any of the required S corporation tax forms. Also of note, be sure to abide by all the state income tax requirements for your business entity (i.e. LLC or C corporation). The S corporation tax status is only relevant for federal income taxes filed with the IRS. This resource does not address state business tax issues.

## Creating an S Corporation: Next Steps

By now you might be thinking that S corporations are great and that you want one for your farm operation. Or perhaps your friend has an S corporation or your accountant has recommended that go that route. So now you might thinking, “Why aren’t you telling me exactly how to form an S corporation?” Well, like we explained in earlier this chapter, unlike other entities, the S corporation is not actually formed at the state level. To become an S corporation, you first have to form an entity—a C corporation or an LLC—at the state level. Once this is done, that entity can become an S corporation by filing the necessary paperwork with the IRS—as outlined in the previous section. Forming an S corporation is basically electing S corporation federal tax status for your regular corporation or LLC. A lot of people don’t think about it this way, so the S corporation is often referred to as a separate entity. For all federal tax purposes it is a separate entity, but you first need a corporation or LLC at the state level.

What’s next then? Well, now that you have read this chapter on S corporations and have an understanding of the various benefits, eligibility criteria, and requirements—and have spoken to your accountant to confirm that the S corporation is the best entity for you—your first step is to choose the best state level entity for your farm operation. Review the chapters on C corporations and LLCs (part 2, chapters 2 and 3 of the **Farmer’s Guide to Choosing a Business Entity**) to help you through this process.

Note that a B corporation can also elect the S corporation tax status, so that is another option for you if it’s recognized in your state. You can learn more about B corporations in chapter 5.

Once you’ve decided on the state level entity, you’ll then need to go through the process of setting that entity up in your state. The chapters on each entity outlines how this is done. In addition, the C corporation and LLC chapters each have a **Going Deeper** section which provides checklists and sample organizational agreements (bylaws for the C corporation and operating agreement for the LLC) as well as checklists that include a step-by-step process for setting the entity up at the state level and electing S corporation tax status with the IRS. If you go the C corporation route, be sure to pay particular attention to Article VI of the **Momma Earth Farm Inc. Bylaws**, which include S corporation specific provisions. If you choose to form an LLC, be sure to pay particular attention to Articles 3.1, 6.1, and 7.6 of the **Extensive Operation Agreement for Three Sisters Farm, LLC**, which all include S corporation specific provisions.

In sum, these are the steps that people mean when they say “forming an S corporation.”

Do you have questions or thoughts on how to improve this document? We want to hear from you. Please email us!

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