



Where Did All The "S" Corporations Come From?

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You just formed your medical practice in Alabama, and you either chose a professional corporation (a "PC") or an LLC. If you went with a PC, you get to choose between an "S" corporation ("S corp") or a "C" corporation ("C corp") for federal and state tax purposes, both named after the Internal Revenue Code (the "Code") Subchapter that governs their taxation. Using an LLC provides an additional income tax option, a partnership, while still allowing you to choose S corp or C corp treatment. But which one is best for you, and why do so many tax practitioners recommend S corps in the medical world?

Avoiding C Corp Double-Taxation

Because C corps are double-taxed -- the corporation pays tax on its own income and its shareholders pay tax again when the remaining income is distributed as a dividend -- you are probably leaning toward an S corp, or, if available, maybe a partnership. Unlike C corps, S corp and partnership earnings are each only subject to one level of tax. Of course, the C corp double-tax has no real effect if the PC pays all of its profits to you or the other shareholders as employee salaries.

But then, your CPA may mention, that salary is also subject to federal and state employment taxes. But just how painful are those employment taxes and is it possible to avoid both the C corp double-tax and employment taxes at the same time?

Employment Taxes

In general, employment taxes are levied on wages/salaries earned for providing services, and the federal version comes in two flavors: social security and Medicare. The current social security tax rate is 12.4%, which is usually split between the employer and the employee. The current Medicare tax rate is 2.9%, and employer and employee split that one too. Of course, because S corp shareholders are often both the employer and the employee, they pay both sides. Similarly, members in LLCs taxed as partnerships pay the combined 15.3% as self-employment tax. Finally, employees making over \$200,000 (\$250,000 for married joint filers) must pay a 0.9% "Additional Medicare Tax," bringing the total potential Medicare tax to 3.8%.

Because social security tax only applies to the first \$118,500 of wages, most employment tax planning concerns only the Medicare tax, which has no upper limit. But given the relatively low 3.8% Medicare tax rate, it is sometimes difficult to generate significant tax savings here. Nonetheless, many still give it a go every year.

Using S Corps to Limit Employment Taxes

Even though partnerships aren't subject to a C corp-like double -tax, the self-employment tax makes them ill-suited for employment tax planning. Enter the S corp, which offers the best of both worlds for the creative and the daring.

The S corp's seemingly magical employment tax-avoidance abilities stem from the Code's "wages" definition and the fact that many S corp owners wear two hats: shareholder and employee. Let's call them "shareholder-employees." The owner's employee salary is subject to employment taxes, but shareholder dividend distributions are not. This creates an incentive to underpay salaries to shareholder-employees. Reducing that salary (and the related employment tax) allows the forgone salary to instead pass through to shareholder-employees as business profits/dividend distributions, and the lower the salary the better. Now the shareholder-employee is seemingly on her way to a perfect tax world, one with no C corp double-tax, and no employment tax, right?

The "Reasonable Salary" Limitation

In fact, since many S corp owners control the company's salaries, why not pay shareholder-employees no salary and effectively zero-out all of the related employment taxes? Well, because the IRS would have a problem with that. A 1974 IRS ruling holds that when S corp shareholders provide services to their corporation, the S corp must pay them "reasonable salaries." The reasonable salary therefore operates as a floor on S corp employment tax planning.

While a reasonable salary is not easily defined, it is best described as the local market rate for the shareholder-employee's services. (Please note this is similar to the fair market value requirement used in the health care fraud and abuse context). In essence, the inquiry becomes an arm's-length one: what would an unrelated company pay the S corp owner if she provided those same services to that company instead of working for her own? A simple concept, sure, but in practice this still leaves a lot of grey area. And grey areas in the tax world often lead to aggressive behavior from both taxpayers and the IRS.

Audit Risks and S Corp Inflexibility

Even if you take a conservative salary position, an IRS auditor, may not agree. Indeed, any professional services S corp that is paying salaries to its shareholder-employees that are less than the S corp's profits should expect IRS auditors to raise the reasonable salary issue. Every little bit counts in the tax world, but an IRS fight (and the related legal and accounting fees) may not be worth avoiding that 3.8% tax.

S corps have other downsides too. For one, they lack the flexibility offered by partnerships, especially when distributing out property like real estate or equipment, and can become unwieldy if you regularly alter ownership percentages. And I haven't even mentioned how easy it is to violate the "one class of stock" rule (especially if your S corp is also an LLC), which could inadvertently turn the S corp into a C corp, triggering a veritable tax bonanza. Maybe the potentially calmer seas of partnership taxation are a better fit, even with that 3.8% tax.

Some Parting Tips

For those soldiering on down the S corp path, a few tips. Analyze shareholder-employee salaries from both a tax perspective and health care fraud and abuse context. Document the analysis, and be prepared to prove why you consider the salary reasonable. And, please, do not, do not, do not pay yourself only distributions with no salary. Instead, decide where you think the reasonable, fair market value salary line lies, and plant your flag. Then, even if the IRS shows up, you have support for your position.

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