

Family Tax Planning Forum

Making an S Corporation Election to Save on Employment Taxes

By Robert S. Keebler

The S corporation election is often thought of merely as a tool to achieve passthrough taxation of C corporation income to avoid the double tax. However, electing Subchapter S treatment may also be a beneficial strategy for owners of sole proprietorships, single-member LLCs or certain partnerships.

The Social Security portion of the self-employment tax is imposed at a 12.4-percent rate on 92.35 percent of income from wages, salaries, tips and Schedule C income up to the Social Security contribution base. This base is \$118,500 for 2015 and is adjusted for inflation. In addition, a 2.9-percent tax is imposed for Medicare with no maximum income base, making the combined rate for most income 15.3 percent.

How the Strategy Works

An S corporation is a flow-through entity that is not subject to tax at the corporate level. Instead, the S corporation's items of income, gain, loss and deduction are passed through to the shareholders. Shareholders who regularly perform services for an S corporation are generally treated as employees under the common law and for tax purposes. Thus, they may receive both salary income and dividends from the corporation. The salary income is subject to self-employment tax, but the dividends are not. By characterizing some of the income received as a dividend, shareholders can significantly reduce their self-employment tax.

Example 1. Beth operates a business as a sole proprietorship. In 2015, the business has \$250,000 of gross income and \$150,000 of deductions leaving \$100,000 of net income. The amount of self-employment tax payable is calculated as follows. The \$100,000 of income is first multiplied by 0.9235, resulting in \$92,350 of income subject to the tax. This amount is then multiplied by 15.3 percent, producing a self-employment tax of \$14,130.

Of this amount, \$11,452 is the Social Security component ($0.124 \times \$92,350$), and \$2,678 is the Medicare component ($0.029 \times \$92,350$). Note that the 0.9235 figure is arrived at by reducing the base for calculating the tax by one-half of the tax on the full \$100,000 of income. Thus, $0.153 \times \$100,000 = \$15,300$. Then, one-half of \$15,300 equals \$7,650, reducing the tax base



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to \$92,350 (\$100,000 – \$7,650). Finally, $0.153 \times \$92,350 = \$14,130$.

Now suppose instead that the taxpayer makes the S election, receives all the stock of the new corporation and characterizes part of the income as a distribution instead of salary. The tax savings are illustrated in the next example.

Example 2. Assume the same facts as in Example 1 except that Beth converts the sole proprietorship into an S corporation and treats \$70,000 of the net income as salary and \$30,000 as a distribution. The distribution is not subject to self-employment tax, so the tax payable is $\$70,000 \times 0.9235 \times 0.153 = \$9,891$. This is a reduction of \$4,240 (\$14,131 – \$9,891). Beth pays the Social Security and Medicare taxes in her individual capacity on only one-half of the salary income but, in effect, she pays the employer’s portion too because she is the sole owner of the business.

Although the tax savings may seem small compared with those from other income tax strategies, over time they can accumulate to a substantial amount. Assume, for example, that the business can reinvest the \$4,239 of annual tax savings to produce an eight-percent return after tax. Chart 1 shows the wealth accumulation over various periods of time.

| | |
|----------|-----------|
| 5 years | \$24,869 |
| 10 years | \$61,409 |
| 15 years | \$115,098 |
| 20 years | \$193,985 |
| 25 years | \$309,896 |

Note that tax savings are possible even if converting to an S corporation does not reduce income below the Social Security contribution base because there is no income cap for the 2.9-percent Medicare component. This is illustrated in the next two examples.

Example 3. Assume the same facts as in Example 1 except that Beth has net income of \$200,000. The self-employment tax payable is shown in Figure 1.

| |
|---|
| $0.124 \times \$118,500 = \$14,694$ (Social Security portion) |
| $+ 0.029 \times \$184,700 = \$5,356$ (Medicare portion) |
| \$20,050 (Total tax paid) |

Example 4. Assume the same facts as in Example 2 except that Beth converts her sole proprietorship into an S corporation and treats \$140,000 of the \$200,000 income as salary and \$60,000 as a distribution. The self-employment tax payable now is illustrated in Figure 2.

| |
|---|
| $0.124 \times \$118,500 = \$14,694$ (Social Security portion) |
| $+ 0.029 \times \$129,290 = \$3,749$ (Medicare portion) |
| \$18,443 (Total) |

The tax savings from avoiding a portion of the Medicare Tax is \$1,607 (\$20,050 – \$18,443).

It should be pointed out that the benefit of shifting income from salary to distribution income is actually somewhat less than the amount calculated in the examples. This is because the S corporation receives a deduction for the amounts paid as salary but not for the amounts paid as distributions.

Forming an S Corporation

While the details are quite complicated, the general prerequisites for making the S election are simple and easily met for many businesses. An S corporation is a corporation that:

1. is a domestic entity;
2. has no more than 100 shareholders;
3. has only eligible shareholders;
4. has only one class of stock; and
5. is not a corporation that is ineligible for S corporation status.¹

Eligible shareholders include individuals (other than nonresident aliens), qualified tax-exempt shareholders, grantor trusts, former grantor trusts for two years after the grantor’s death, electing qualified subchapter S trusts (QSSTs), electing small business trusts (ESBTs), voting trusts, will recipient trusts, Code Sec. 678 trusts and electing Code Sec. 645 trusts for two years after the stock is transferred to the trust.² Ineligible shareholders include insurance companies, financial institutions using the reserve method of accounting, corporations electing to use the Code Sec. 936 possessions tax credit and domestic international sales corporations (DISCs) or former DISCs.

In order to receive subchapter S treatment, Form 2553 must be filed. The form outlines a number of requirements and limitations, none of which are prohibitory for many businesses. The election must be filed within two months

and 15 days after the start of the tax year the entity wishes Subchapter S treatment to begin, and all the shareholders must consent to the election.

Before making the election, taxpayers should make sure that converting to an S corporation would provide an overall benefit and not just self-employment tax savings. The decision should not be made without careful consideration because once made, it may be difficult and expensive to unwind it.

Business organizations other than C corporations that are eligible to make the election include sole proprietorships, partnerships, limited partnerships (LPs), limited liability companies (LLCs), limited liability partnerships (LLPs) and limited liability limited partnerships (LLLLPs). It is important to note, however, that such entities do not have to reorganize under state law to a corporation in order to be eligible for the election. In fact, reorganizing many businesses may have negative consequences, such as increased state taxes and changes in liability protection.

Allocating Income to Distributions

On the surface it might appear that taxpayers should eliminate all the salary income and just make distributions. Unfortunately, the IRS and the courts have required that shareholder/employees be paid reasonable compensation for their services to the corporation. If the shareholder/employee does not receive reasonable compensation, the IRS may re-characterize a portion of distributions as wages and impose self-employment tax on the amounts received. Note that the employee, having been subject to withholding, would not have to make quarterly estimated tax payments with respect to compensation for services, however.

There is no simple test for determining when compensation is reasonable. Neither the Code nor the Regulations provide any specific guidelines. The various courts that have ruled on this issue have generally based their determinations on the facts and circumstances of each case. In *Automotive Investment Development Inc.*,³ the Tax Court summarized the categories of relevant factors as follows:

1. The employee's qualifications and role in the company including factors such as the employee's position, hours worked, duties performed and his or her overall contribution to the success of the company
2. The character and condition of the company, including factors such as the size of the company, the complexity of its business and the general economic conditions
3. A comparison of the employee's compensation with the compensation paid by similar companies for comparable services
4. The salary policy of the company for all its employees and the particular employee's salary history with the company
5. The likelihood that a hypothetical, independent investor would be willing to compensate the employee at the levels paid by the company, taking account of dividends paid and capital growth

No one factor is determinative.⁴ It may be reasonable for a sole shareholder's salary to be larger than that of a non-shareholder/employee because the stockholder's compensation is contingent on the amount of income left after expenses payable.⁵

Conclusion

Converting a sole proprietorship, single-member LLC or partnership to an S corporation can save business owners substantial amounts of self-employment tax over time. Provided that the taxpayer does not get greedy and set salary income too low, the strategy should pass muster with the IRS.

ENDNOTES

¹ Code Sec. 1361(b).

² If the S corporation is a Code Sec. 581 bank corporation or a depository institution holding company, an IRA can be a shareholder (Code Sec. 1361(c)(2)(A)(vi)).

³ *Automotive Investment Development, Inc.*, 66 TCM 57, Dec. 49,140(M), TC Memo. 1993-298.

⁴ *G.L. Wallace Est.*, 95 TC 525, Dec. 46,977 (1990).

⁵ *Milford Motor Co.*, DC-NH, 56-1 USTC ¶19477, 51 AFTR 1222.

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