"Is there still a role for S Corps? Most definitely."

Carl J. Grassi | Wednesday, February 8, 2017

With the start of a new year, eligible corporations and limited liability companies once again have a window in which to make an election to be taxed as an S corporation. We have seen many tax changes in the last five years, and some owners are still trying to decide what is the best type of entity for operating their business.

Since the advent of limited liability companies, many businesses have been formed in this legal format. Is there still a role for the S corporation? The answer is clearly yes, and one significant reason relates to the interplay between self-employment taxes and the net investment income ("NII") tax.

The NII tax is a 3.8% tax on investment income to the extent that the taxpayer's adjusted gross income (with some modifications) exceeds certain thresholds. The term "investment income" includes almost any income derived from passive business activities, including allocations of business income from S corporations, LLCs and partnerships if the owner is not active in the business.

Although active owners of partnerships and LLCs will not be subject to the NII tax, they will most likely be subject to a 3.8% tax on self-employment income if their income is above the same thresholds for the NII tax referenced above. LLC and partnership owners with incomes over the thresholds will therefore in most cases pay the 3.8% NII tax if they are inactive in the business, or the 3.8% self-employment tax rate if they are active.

If the business is operated as an S corporation, while salary payments to the owner would still effectively be subject to the 3.8% Medicare tax on the wages paid by the S corporation, allocations of business income to an S corporation owner who is active in the business are not subject to either the Medicare or NII tax.

Many of the businesses that have taken advantage of this rule are personal, service-type businesses. In these situations, the employee/shareholder service provider is paid a salary from the (usually 100% owned) S corporation, and the remaining profits are allocated and distributed to the employee/shareholder as corporate earnings. In order for the income to be considered taxable to the corporation and not the employee/shareholder, there are a number of rules including: the compensation paid to the employee/shareholder cannot be unreasonably low; the shareholder providing the services must be an employee of the corporation; and the corporation must have a contractual agreement with the party that is receiving the services.

This third requirement was illustrated in a recent Tax Court case where a taxpayer was a financial planner and entered into a representative agreement in his personal capacity. Several days later, he formed a new corporation and made an election to have it taxed as an S corporation. He appropriately entered into an employment agreement with his new corporation and was paid a salary. Several years later he entered into a broker contract with a financial institution, but again did so in his individual, and not the corporate capacity.

The revenue from these contracts was reported as business income on the S corporation's return and was allocated to the individual employee/shareholder. No employment taxes were paid on this amount, and although the tax years at issue preceded the imposition of the NII tax, these allocations would have been exempt from this tax also since the individual was active in the business.

The court in this case focused not on the amount compensation paid, but on the fact that there was in fact no agreement between the taxpayer's customers and his corporation since he had signed both agreements in his individual capacity. Although the identity of the party to the contract would seem to be a formality since the corporation was completely controlled by the individual employee/shareholder, the Tax Court found that the service contracts were not with the corporation, and therefore the income generated from those contracts was taxable to the individual.

The ability to avoid self-employment (and NII) tax using an S corporation to provide personal services therefore comes with several caveats. First, the wages paid to the service provider by the corporation must be reasonable for the services provided. Second, the appropriate agreements must be in place between both the employee and the corporation, and the corporation and the customers. Failure to meet these requirements will likely result in an IRS challenge upon audit as it did for the taxpayer in the recent Tax Court case.

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