

#32: S-Election to Save Employment Taxes

The S-election is generally thought of as a tool merely to achieve pass-through taxation of C corporation income to avoid the double tax. However, other domestic entities are eligible for Subchapter S treatment too. Electing Subchapter S treatment may also be a beneficial strategy for many pass-through entities because a portion of income will not incur employment taxes.

Business organizations, other than 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 (LLLPs). It is very 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.

While the details are quite complicated, the general prerequisites to make the S-election are simple and easily met for many businesses:

- (1) Be a domestic entity;
- (2) Have only allowable shareholders which include individuals, who are not nonresident aliens, and certain trusts and estates;
- (3) Have no more than 100 shareholders;
- (4) Have only one class of stock; and
- (5) Not be ineligible; e.g., certain financial institutions and insurance companies.

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. Nevertheless, it should be noted that the election must be filed within two months and 15 days of the start of the tax year the entity wishes Subchapter S treatment to begin and all the shareholders must consent to the election.

However, before consulting a qualified professional to assist you or your client to make the S-election, the benefit of doing so must be analyzed. For pass-through entities, the S-election may be beneficial because a portion of income will not be subject to employment taxes. These taxes include Social Security Tax, Medicare Hospital Insurance Tax, and the Additional Medicare Tax.

Social Security Tax

Social Security Tax is assessed against all wages, salary, tips and Schedule C income at a rate of 12.4%. It is only assessed on income up to the contribution base (\$168,600 in 2024). Employees and employers each pay half of the tax. Self-employed taxpayers pay 12.4% of 92.35% of their wages, salary, tips and Schedule C income.

Example 1: Mary is self-employed and expects to make \$165,000 in 2024.

Income	\$ 170,000
2024 contribution base	\$ 168,6000
Lesser of income or contribution base	\$ 168,600
92.35% of taxed income	\$ 155,702
Social Security Tax owed	\$ 19,307

The Medicare Hospital Insurance Tax

The Medicare Hospital Insurance Tax is assessed against all wages, salary, tips and Schedule C income at a rate of 2.9%. Employees and employers each pay half of the 2.9% tax while the self-employed pay 2.9% of 92.35% of their income.

Example 2: Mary is employed and her salary is \$170000 in 2024

Income	\$ 170,000
Employer's share	\$ 2,465
Employee's share	\$ 2,465
Total 2.9% Medicare Tax owed	\$ 4,930

The Additional Medicare Tax

The Additional Medicare Tax is assessed at a rate of 0.9% against all wages, salary, tips and Schedule C income that exceeds a threshold amount. Unlike the Social Security tax and 2.9% Medicare tax, employees are responsible for the entire 0.9% tax. Income of the self-employed which exceeds a threshold amount is also subject to the 0.9% tax. The following table shows the threshold amounts, which are not indexed for inflation, by filing status:

Filing Status	Threshold
Married Filing Jointly	\$ 250,000
Married Filing Separately	\$ 125,000
All Others	\$ 200,000

Example 3: Mary is single and employed. Her salary is \$240,000 in 2024.

Income	\$ 240,000
Applicable Threshold	\$ (200,000)
Income Subject to the 0.9% Tax	\$ 40,000
Employer's Share	\$ 0
Employee's Share	\$ 360
Total 0.9% Medicare Tax Owed	\$ 360

The S-Election

The S-election allows a business owner to save on these employment taxes because earnings can be segregated between wages and distributions. Wages are subject to employment taxes, whereas distributions are not. Thus, it is advantageous to treat amounts received from an S corporation as distributions rather than as wages to the maximum extent possible.

How earnings are allocated to each category is contentious and unclear. “There are no specific guidelines for reasonable compensation in the Code or the Regulations. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of each case.”¹⁵⁰ However, it is clear the wages paid to the business owner-employee must be reasonable; i.e., not too low. If the wage compensation is determined to be unreasonably low the Service has the authority to subject a portion of the distributions to employment taxes;¹⁵¹ i.e., the Service will treat part or all of the distributions as wages. Reasonable compensation varies by what the business owner-employee does for the business.¹⁵² The source of revenue is a key consideration and the Service has created three categories:

- (1) Services of the shareholder;
- (2) Services of non-shareholder employees; and
- (3) Capital & equipment.¹⁵³

Revenue derived from (2) and (3) should not be allocated as compensation whereas revenue derived from (1) should be.¹⁵⁴ A qualified professional should help you determine how to allocate earnings between each category.

Example 4: Mike, married filing jointly and is the 100% owner and active manager of a factory. He has \$5,000,000 of equipment and 35 manufacturing employees. The business is organized as an LLC and he reports \$1,500,000 in net profit annually on which he pays Social Security and Medicare taxes. His profits increase by 3% each year and his discount rate is 5%.

Assume a qualified professional determined a fair wage for Mike, if he was merely an employee rather than the business owner, is \$500,000.

¹⁵⁰ Wage Compensation for S Corporation Officers, FS-2008-25, August 2008, available at <http://www.irs.gov/uac/Wage-Compensation-for-S-Corporation-Officers>.

¹⁵¹ Rev. Rul. 74-44; Rev. Rul. 73-361; *RADTKE*, 895 F.2d 1196; *C.D. ULRICH, LTD. v. U.S.*, 692 F. Supp. 1053; *YEAGLE DRYWALL*, 54 Fed. Appx. 100.

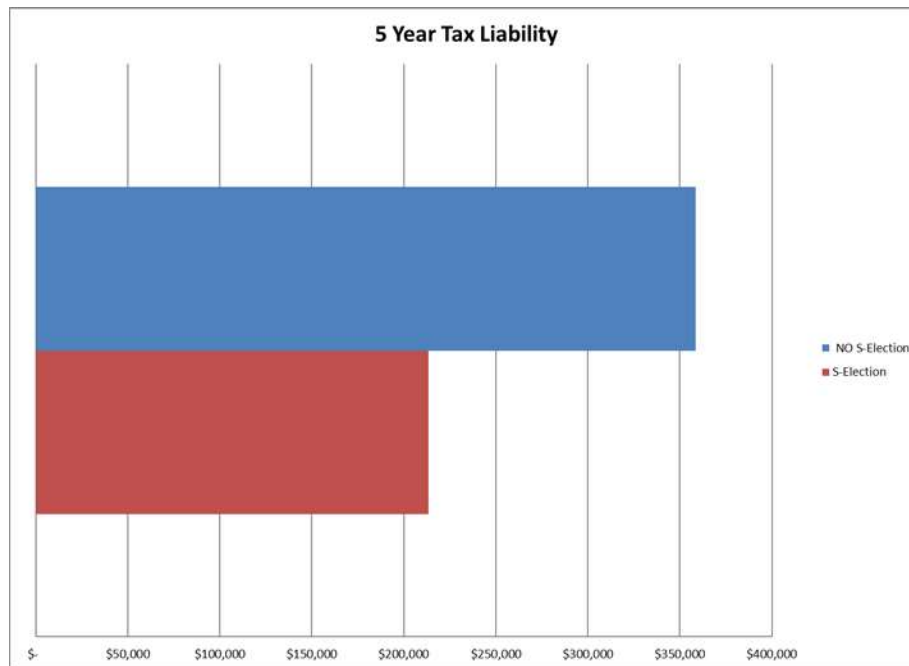
¹⁵² <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/S-Corporation-Compensation-and-Medical-Insurance-Issues>

¹⁵³ *Id.*

¹⁵⁴ *Id.*

5-Year Summary

	NO S-Election	S-Election	Difference
2019 Tax Liability	\$ 70,419	\$ 41,280	\$ 29,139
2020 Tax Liability	70,969	41,875	29,094
2021 Tax Liability	71,553	42,507	29,045
2022 Tax Liability	72,034	43,028	29,006
2023 Tax Liability	73,545	44,665	28,880
Total Taxes Over 5-Year Period	<u>\$ 358,519</u>	<u>\$ 213,354</u>	<u>\$ 145,164</u>
Present Value Adjustment	\$ 358,519	\$ 213,354	\$ 145,164



Adjusted for present value, Mike will save \$176,856 over the next five years if he chooses to make the election.¹⁵⁵

As shown above, the savings of making the S-election can be significant. However, this strategy can only be applied to a limited number of taxpayers and it is especially prudent to involve an experienced professional when making the S-election. A cursory examination of eligibility and computing the potential savings are the essential first steps in employing the strategy. If made deliberately and with care, the S-election is powerful.

¹⁵⁵ The tax liability calculations in this example were calculated using the “Employment Tax Analyzer” created by Bloomwood. The COLA is assumed to be 2.8%. Disclosures

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