CPA
Practice Advisor

time and this is their side business. Wouldn't it just make sense to form an LLC and ...

Craig Smalley • May. 16, 2017

I was part of the big lie, which was that every new business needed to be taxed as an S-Corporation. I agreed because as a sole proprietorship, the business owner exposes the entire amount of what they make to self-employment tax, which is really just FICA taxes. But that isn't the 100% truth. A shareholder of an S-Corporation still has to reasonably compensate themselves. The topic of reasonable compensation could be its own article, but I will briefly touch on it by saying that an S-Corporation shareholder has to pay FICA taxes in some form or another.

Generally, my advice was to form an LLC and then have it taxed as an S-Corporation. But there are many things to examine here. Let's say that someone is working full time and this is their side business. Wouldn't it just make sense to form an LLC and do nothing with it? Because they are spending less than $500 a year in the business,

than 2% shareholder of an S-Corporation.

Another important disadvantage of an S-Corporation concerns ownership. An S-Corporation limits the type of shareholders allowed, the number of shareholders, and the type of ownership interest shareholders may have.

For example, to be an S-Corporation, you need to be able to file a Form 1040, which means that you have to be a US Citizen, Green Card Holder, or have been in the US continuously for 180 days with a Social Security Number.

Then there is the one class of stock rule. One of the benefits of an LLC is that the operating agreement can be written to favor any member. However, if you are planning on electing to be taxed as an S-Corporation, that can be considered a different class of stock, and nullify the election.

To find a reasonable salary for an S-Corporation owner/employee, consider how you would find a reasonable salary amount for any new employee. The IRS guidelines suggest you look at the following factors to determine "reasonable" salaries for your corporate officers:

- *Training and experience*
- *Duties and responsibilities*
- *Time and effort devoted to the business*
- *Dividend history*
- *Payments to non-shareholder employees*
- *Timing and manner of paying bonuses to key people*
- *What comparable businesses pay for similar services*
- *Compensation agreements*
- *The use of a formula to determine compensation*[1]

I'm not saying that S-Corporations are wrong for everyone. What I am saying is that

known:

- Double taxation of appreciated assets on sale or dissolution;
- High corporate income tax rates on annual income in excess of $75,000; and
- Tax traps for accumulated earnings and personal holding companies.

However, there are also significant advantages, especially for non-personal service corporations (non-PSC's):

- Low tax rates on the first $75,000 of annual income for non-PSC's;
- Availability of a fiscal year;
- Superior fringe benefits for owner-employees;
- Different audit potential than pass-thru entities;
- Sec. 1202 reduced rate of capital gains taxation on the sale of qualified small business stock; and
- Sec. 1244 ordinary loss deduction for a failed small business C-Corporation.

So, we have a client that comes to us. He is in the technology field and makes $500,000 between him and his wife, and the C-Corporation will gross $1 million. Let me show you how quickly that disappears.

Let's say that you pay your employees $200,000 a year. You pay yourself $250,000, then you put $53,000 into a 401k and $250,000 into a defined benefit plan. That is $303,000 that you are putting away tax free. Then you have a medical reimbursement plan and reimburse yourself $25,000. You also pay for health insurance for $75,000, company car for $50,000, not to mention other tax free fringe benefits for another $50,000. That $1 million is now taxable income of $47,000 taxed at 25% instead of 39.6%. Just to play devil's advocate, let's say that you have to take a dividend out of the corporation; then you pay tax on your personal return at a measly 15%.

Is your kid in college? They can work for you and you can pay their tuition up to

The audit potential for C-Corporations and their owners is different than it is for other entities and their owners. There is no income or loss pass-thru from a C-Corporation to raise the owners' individual audit potential. An audit of a C-Corporation may lead to adjustments that result in taxation at unplanned high corporate income tax rates—or worse, as a dividend to shareholders, resulting in double taxation. However, the owners of a C-Corporation generally will not be liable for any additional taxes assessed to the C-Corporation due to an audit. If a tax assessment exceeds the value of the business, the owners may be able to simply abandon the bankrupt C-Corporation and walk away from tax debt. In a pass-thru or disregarded entity, the tax liability of the business falls directly onto the owners.[2]

There are so many reasons to look at a client as a whole. Whether you select an LLC taxed as an S-Corporation, a partnership, or simply an old-fashioned C-Corporation, it all depends on your client.

---

[1] What is a Reasonable Salary for an S Corporation Officer? By Jean Murry

[2] Advantages of a C Corporation AICPA

Craig W. Smalley, MST, EA, is the Founder and CEO of CWSEAPA, PLLC. He has been admitted to practice before the Internal Revenue Service as an Enrolled Agent and has a Master's Certificate in Taxation from UCLA. In practice since 1994, Craig is well-versed in U.S Tax Law and U.S. Tax Court cases, and specializes in individual, partnership, and corporate taxation for high-net-worth clients; entity structuring and restructuring; and representation before the IRS regarding negotiations, audits and appeals. Craig is currently a columnist for CPA Practice Advisor and

CPA Practice Advisor is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors.