the type of ownership interest shareholders may have.

Craig Smalley • Jun. 27, 2017

The Big Lie About S-Corporations

By Craig W. Smalley, MST, EA

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, the income or loss that they are making is passive. Why go the extra mile and elect for the business to be taxed as an S-Corp? When filing for an S-Election, you create a bunch of hard and fast rules that must be followed.

First off, how are you going to compensate yourself? If the company is making $250,000 in profit, reasonably you would have to compensate yourself at least $125,000. That is over the limit of Social Security. Not to mention, it exposes you to additional taxes such as Net Investment Income Tax (NIIT) on any investment income. Then, you aren't allowed to pay any fringe benefits to yourself as a more than 2% shareholder of an S-Corporation.

Another important disadvantage of an S-Corporation concerns ownership. An S-

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