New Case Highlights Tax Saving Opportunities and Risks

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Many physicians and other professionals use S-Corporations (S-Corp) to conduct their practice. For a number of reasons this is often a good idea. An S-Corp can help limit personal liability – not from medical malpractice claims – but from other obligations of the corporation. For example if your corporation leases office space or equipment, you have no legal responsibility for payment unless you have personally guaranteed the contract. A Limited Liability Company would achieve the same result but physicians are generally prohibited from practicing medicine in an LLC, so the choices for how to organize your practice are usually restricted to partnerships, sole proprietorships and corporations.

The traditional problem with corporations is that they are treated as separate taxpaying entities, which means that they have the potential to produce two layers of tax, once at the corporate level and again at the shareholder level. The corporate tax can produce some nasty and surprising tax problems, but fortunately, the law allows shareholders to opt out of the corporate tax by filing an S-Corp election if they meet certain qualifications. Under this treatment, all the income of the S-Corp flows through to the shareholder's personal return and is taxed there – only once – similar to a sole-proprietorship or a partnership.

Profits or Wages?

With this long-standing and simplified tax regime it would seem that S-Corps should be easy to manage and free of significant tax issues. But, in fact, S-Corps have a unique hybrid status, capable of producing savings not available to other business entities. These benefits are created by particular grey areas within the tax law which treat certain types of business income more favorably than others. If income can be characterized to take advantage of the lower available rates, substantial savings can be generated.

More specifically, the income generated through an S-Corp and reported on the shareholder's return can be classified as *wages* or as a *profit distribution* based upon a variety of factors. And the outcome of that determination matters a great deal because amounts treated as wages are subject to payroll taxes while profit distributions are not. Depending on the amount involved, the difference in taxes can be substantial. For example, in years after 2011, the FICA (Social Security) tax is 12.4% of the first $106,800 of salary and the separate Medicare tax is 2.9% of all salary without any upper limitation. If an S-Corp has profits of say $250,000, taking that full amount as salary results in combined payroll taxes of roughly $20,000. If the amount of salary was instead lowered to $50,000 with the balance claimed as a profit distribution, tax savings for the year would be about $11,000.

What is "Reasonable Salary"?
The issue in most cases turns on what is a reasonable salary under the circumstances? What amount of corporate income is properly allocable to invested capital and what amount represents income from the shareholder's services? It's not an easy question.

A recently decided case illustrates the way this issue has been treated. In *David E. Watson P.C. v. U.S.*, Mr. Watson's S-Corp was a partner in an accounting firm. In 2002 and 2003 the partnership distributed $203,854 and $175,470 respectively to Watson's S-Corp. But rather than treating that amount as salary for his services, Watson claimed a salary of only $24,000 in each year with the balance labeled as profit distribution. Based on the payroll taxes then in effect, this resulted in a tax savings of nearly $20,000 over the two year period.

The IRS rejected this treatment and asserted that the reported salary of only $24,000 was unrealistically low in relation to the pay for other accountants with similar experience. The point was made that even accountants coming directly out of school make far more than the amount claimed. Ultimately the District Court decided that a reasonable salary amount for Watson should have been about $90.000 per year and full payroll taxes were due on this amount. The balance of the corporate income was treated as profit distribution.

Determining what is a profit distribution and what is salary is the subject of a longstanding game of cat of mouse between the IRS and taxpayers. The IRS's position is that amounts of earnings attributable to corporate capital or assets may be properly classified as a profit distribution but that payments for shareholder services must be treated as wages.

In a medical professional corporation, it is often true that a large percentage of the income is related to services performed by the shareholder, but there are significant exceptions. If profits are generated by the services of non-shareholder employees or from charges for lab work, equipment use, the sale of products or from other investments, then income earned from these activities might not be related to the physician-shareholder’s services. In these cases, the allocation between profits and wages is subject to considerable interpretation and the amounts claimed for each can significantly impact the amount of payroll taxes which may be owed. Although Congress may take some steps in the future to clarify these issues, for now the outcome of disputes on this issue depends on the circumstances involved and you should certainly obtain the assistance of an experienced tax advisor when navigating the rocky landscape of tax strategies.