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Is the S Corporation Election Right for Your Firm?

BY JOHN HERMANSON AND MATTHEW MUNCEY

The business entity you select for your firm has enormous implications for your annual tax liability. In addition, determining whether (or if) to make additional tax elections with the IRS can be one of the more confusing aspects when establishing a law firm. Which structure is right when you start your firm? Should you start with one structure and modify it down the line? What tax advantages could you gain from a change?

Most firms opt for a structure that limits personal liability and avoids double taxation in the form of a pass-through entity like a limited liability corporation (LLC) or limited liability partnership (LLP). These structures eliminate the double taxation inherent in C corporations, where corporate income is taxed once and payroll is taxed again. But by using an LLC or LLP instead of a C corporation, the tax consequences are still substantial; the income from the business flows through to your personal return and is subject to income tax at your individual tax rate, Social Security (6.2%) and Medicare (1.45%). And the business is liable for the other half of the employee's payroll taxes (another 6.2% + 1.45%). That 15.3% in addition to federal and state income tax is sometimes referred to as the small business tax.

The best way to save money on taxes is to reclassify some of that income, and that process is made much easier if an LLC or LLP elects to be treated as an S corporation for tax purposes. There are a few important considerations. First, taking the S corp election does not change the structure of your company; it changes the way you file the taxes. Instead of filing Schedule C on your personal return (single-member LLC) or Form 1065 (LLPs and multi-member LLCs), you will file a separate S-corporation return (Form 1120-S). So if you are incorporated as an LLC, you will stay an LLC, but you will be treated as an S corporation when you file your taxes.

Who Can Take the S Corp Election?

There are a few rules about who can take the S corp election, including:

- You must be a domestic corporation and file Form 2553.
- You must have no more than 100 shareholders. Spouses and their estates can count as only one.
- Your shareholders must be only individuals, estates, exempt organizations, or certain trusts.
- You may not have resident alien shareholders.
- You can only have one class of stock if you have issued stock.
- You must be willing to have a 52- to 53-week tax year that ends on December 31.

Most law firms can meet these requirements to qualify for the S corp election, but maintaining that status to minimize taxes requires an additional step: paying owners a fair salary. The S corp election still treats your company as a pass through, meaning income flows to your

SAMPLE LAW FIRM, LLC FILING AS LLC

ADJUSTED GROSS INCOME	FEDERAL TAX (24%)	COLORADO STATE TAX (4.63%)	PAYROLL TAX (15.3%)	TOTAL TAX LIABILITY
$125,000	$30,000	$5,787.50	$19,125	$54,912.50

SAMPLE LAW FIRM, LLC FILING WITH S CORP ELECTION

ADJUSTED GROSS INCOME PAID AS SALARY	FEDERAL TAX (24%)	COLORADO STATE TAX (4.63%)	PAYROLL TAX (15.3%)	TOTAL TAX LIABILITY
$75,000	$18,000	$3,472.50	$11,475	$32,947.50
ADJUSTED GROSS INCOME PAID AS DISTRIBUTIONS	**FEDERAL TAX (24%)**	**COLORADO STATE TAX (4.63%)**	**PAYROLL TAX (15.3%)**	**TOTAL TAX LIABILITY**
$50,000	$12,000	$2,315	**$0**	$14,315
TOTAL TAX LIABILITY	**$47,262.50**	**TOTAL SAVINGS**	**$7,650**	

personal returns and is not subject to payroll taxes. But the IRS requires that shareholders of S corporations who also perform services for those businesses receive a salary. That salary is subject to payroll taxes, and S corporation shareholders who failed to pay their share of payroll taxes have had their S corporation status revoked, leading to additional taxes and penalties. To avoid that unfortunate situation, there are two ways to compensate shareholders:

- Pay yourself a reasonable salary. This is the amount you would pay another person to do your job or the job of each shareholder (owner). This is taxed at the same rate as an LLC.
- Pay earnings on top of your reasonable salary as a distribution. The money distributed to shareholders in this fashion is not subject to the 15.3% payroll tax, which lowers tax liability and saves money.

What does the IRS consider a "reasonable" salary? That depends on comparable salaries in your area. Websites like salary.com and glassdoor.com are great places to start comparing.

The Bottom Line

Is all of this extra work worth it? Take a look at the tables above. This example is for a single owner who is not married, but it could easily translate to multiple owners and would apply for those filing as married with some bracket adjustments.

This is a simplistic example, and there are lots of possible tax scenarios that will vary based on individual circumstances. However, the basic math does not lie: For many firms that pay their owners more than $80,000 per year, the S corporation makes sense.

Other Advantages

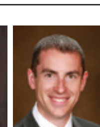
There are two other advantages to taking the S corp election:

- You can take distributions monthly, quarterly, or annually. This allows for some flexibility in cash flow. Many small businesses have cash flow issues, and this can help provide a cushion.
- You can enhance business operations. The amount of each distribution is based on how the company is doing. This can help encourage all partners to ensure that business is running at peak efficiency.

This raises the question: Why don't more businesses elect S corp status? Most small businesses are unfamiliar and/or don't have advisors to explain the options. In addition, most small businesses don't have the infrastructure to handle the payroll requirements and forms necessary to administer this change. Hiring a professional can help.

Conclusion

Regardless of your business structure, the S corp election can be a good option to lower your tax liability and save money. It is not for everyone, but if you've been in business for a while and have built a firm that is bringing in a substantial profit, this election may save you money. CL

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