

Tax Structure of a Professional Services Entity: C Corporation v. S Corporation

For many professionals such as accountants, dentists, veterinarians, physicians and surgeons, the professional corporation entity offers significant benefits as an organizational structure. Generally, a professional corporation can be established by a group of individuals in the same profession and can provide each professional with personal liability protection from the malpractice of his or her colleagues. A professional corporation by default is a C corporation for tax purposes but can elect to be treated as an S corporation subject to tax on a flow-through basis similar to a partnership.

A variety of factors must be considered when selecting between the C and S status. An S corporation eliminates the double taxation of income and 35% flat rate for C corporations. However, an S corporation does not have the ability to provide shareholder-employees with the more generous employee benefits available to a C corporation. In addition, the tax treatment of payments made to shareholder-employees is significantly different under the two regimes.

It is generally more beneficial in a C corporation to characterize payments to shareholders as salary rather than dividends. When dividends are paid, the funds have already been subject to tax at the corporate level and will be taxed a second time at the shareholder level. Even with a 15% dividend tax rate, the key cost of a dividend is actually 44.75% (35% corporate level + 9.75% for the individual representing 15% of the untaxed portion of corporate profits). In contrast, salary payments provide a deductible expense to the corporation effectively creating only one layer of tax at the employee's personal income tax level. The avoidance of the corporate level tax can be significant due to the 35% tax rate applied to C corporations. In comparison, it is more beneficial in the S context to characterize payments as distributions of corporate net income rather than salary. The primary reason for this preference is that the IRS has ruled that S corporation distributions are not subject to self-employment taxes, including the employee's share of FICA and Medicare tax and the employer's share of FICA, Medicare, FUTA, state and other payroll taxes; salary payments from an S corporation, in contrast, are subject to such taxes.

Regardless of the corporation's characterization of payments, under both situations described above the IRS has recharacterized the payments as the less beneficial type of payment. Several examples are available in which the IRS has recharacterized salary paid by a C corporation and treated it as a dividend or recharacterized a distribution by an S corporation and treated it as salary. Despite the numerous cases recharacterizing payments to employee-shareholders, it is difficult for professional corporations to determine with any degree of certainty what constitutes a "reasonable" allocation of payments between profits from investment (dividend or distribution) and compensation for services rendered (salary). However, with proper planning and various preventative measures, an allocation can be designed to maximize the likelihood the preferred character of the payments and the related tax benefits will be upheld.

In order to protect the compensation deduction in the C corporation context a professional corporation should:

1. Pay some amount of dividends when profits are generated;
2. Pay shareholder bonuses no more frequently than quarterly rather than whenever cash is available;

3. Have employment agreements with its shareholders that contemplate unreasonable compensation issues and can be used to justify compensation payments;
4. Document salary decisions and bonus payments in the corporate minutes.
5. Consider allocating (in the minutes) a salary payment as payment for prior years in which the shareholder-employee was under-compensated such as lean years during the infancy of the business;
6. Consider providing at least some non-shareholders' bonuses simultaneously with bonuses to shareholder-employees;
7. Have the shareholders enter into a salary repayment agreement in which the shareholders agree to repay the corporation any amounts determined by the IRS to be unreasonable compensation.

In order to protect the distribution treatment of payments in the S corporation context a professional corporation should:

1. Pay some salary, especially if there is only one shareholder and the income is from such shareholder's services. Make the salary regular and consistent. An easy audit flag is an S corporation with no salary payments at all.
2. Document salary payments in the corporate minutes. Document shareholder distributions in the corporate minutes. To the extent profits can be credited to sources other than the shareholder's services, note that in the minutes. Be diligent about documentation without overdoing it.
3. Do not use the corporate checking account to pay personal bills and then treat such payments as distributions or allow a shareholder to withdraw funds at his or her discretion. The only distributions used should be scheduled periodic distributions based on profits of the corporation.