

Huge Tax Savings for S Corporations

BY ROBERT W. OLSON, JR.¹

Significant incentives already exist that make the S corporation the preferred entity for the individual business owner, as opposed to the unincorporated sole proprietorship, LLC, or ordinary “C” corporation.² In addition to the limited liability protection afforded by incorporation, S corporations allow business owners to achieve significant tax savings through the reduction of payroll taxes. However, the new Tax Cuts and Jobs Act (“TCJA”) has added significantly to those incentives. In order to understand this new incentive, we first need to understand a few interrelated concepts and how they created the old S corporation incentives: payroll tax, **“Salary”** (also known as earned income or wages), and **“Profits”** (also known as net income in excess of wages, and as distributions when paid out to the business owner).³

Payroll Tax. Any Salary paid to the business owner is subject to both income tax and payroll tax.⁴ The payroll tax consists of contributions for (a) Social Security (12.4%) for all earned income up to the annual FICA cap (\$128,400 in 2018), (b) Medicare (2.9%) for all Salary with no upper limit, and (c) the Hospital Insurance Tax (0.9%), starting at Salary of \$250,000 for married individuals (\$200,000 single) with no upper limit.

Salary vs. Profits. Business owners operating as S corporations are allowed to limit their Salary to a reasonable portion of their net business income (gross income less deductible expenses, or **“Net Income”**), and allocate the remainder to Profits (Net Income in excess of Salary). Profits and Salary are subject to personal income tax at the same tax rates, but only Salary is subject to payroll tax.

Payroll Tax Savings on Profits. The payroll tax savings available on Profits are immense and are directly related to how much Net Income is allocated to Profits (as opposed to Salary). To the extent Net Income is excluded from Salary and allocated to Profits, the business owner saves 15.3% on the excluded amount up to the annual FICA cap, 2.9% from the annual FICA cap up to \$250,000 for married taxpayers (\$200,000 single), and 0.9% over that amount.⁵ The annual payroll tax savings for a married taxpayer with Net Income from \$140,000 to \$420,000 can exceed \$8,000 per year:



S Corporation Payroll Tax Savings:

Net Income	Salary ⁶	Savings ⁷
\$70,000	\$35,000	\$5,034
\$140,000	\$60,000	\$9,213
\$210,000	\$70,000	\$8,645
\$280,000	\$80,000	\$8,423
\$350,000	\$100,000	\$6,854
\$420,000	\$120,000	\$5,599

New Tax Deduction: §199A. The TCJA, signed into law on December 22, 2017, adds another huge incentive for business owners to operate as S corporations. This new incentive is Internal Revenue Code (**“IRC”**) §199A, which grants S corporations a new tax deduction of up to 20% of their “qualified business income” (**“Qualified Income”**).⁸ With many exceptions and limitations (discussed in part below), Qualified Income is equal to an S corporation’s Profits. Therefore, the same tax savings technique applies to §199A deductions as payroll tax reduction: convert Net Income into Profits (rather than Salary).

No §199A Limitation under \$315,000. Exceptions and limitations to §199A don’t kick in until total personal taxable income (**“Total Income”**) exceeds \$315,000 for married couples (\$157,500 single). If we assume this maximum amount for a married couple with Salary of \$90,000 and Profits of \$225,000, the TCJA provides an additional \$10,800 in annual tax savings.⁹ For the unmarried business owner with \$45,000 in Salary and \$112,500 in Profits, the TCJA provides an additional \$5,400 in tax savings.¹⁰ When added to payroll tax savings, business owners can reduce their annual tax burden by up to \$20,000 for married couples (\$18,800 single) by converting their business to an S corporation. That’s real money in anyone’s book.

Limitation #1: Deduction Capped over \$315,000.

The first major limitation to the §199A deduction is that 20% deductibility of Qualified Income is limited by a formula when Total Income exceeds \$315,000 (\$157,500 single) over the next \$100,000 in Total Income (\$50,000 single), until Total Income reaches \$415,000 (\$207,500 single). In this range, the §199A deduction on the entire Qualified Income (not just that in excess of the starting point) is capped at the lesser of 20% of Qualified Income or 50% of Salary.¹¹ For example, a married business owner with S corporation Net Income of \$350,000, split between \$200,000 in Qualified Income and \$150,000 in Salary, calculates their §199A deduction as follows:

$$(\$415,000 \text{ minus } \$350,000) / \$100,000 \\ = 65\% \text{ of } §199A \text{ deduction}$$

The lesser of 20% of \$200,000 or 50% of \$150,000, times .65

which equals the lesser of \$40,000 or \$75,000, times .65

which equals \$40,000 times .65

which equals \$26,000.

Therefore, this business owner is allowed a deduction of \$26,000, providing tax savings of \$11,270. The astute reader now realizes junior high algebra would help determine the “sweet spot” between Qualified Income and Salary to maximize this deduction. For those who thought algebra was unnecessary in real life, the deduction is maximized when Net Income is allocated 5/7 (71.43%) to Qualified Income and 2/7 (28.57%) to Salary. That means that in our “Net Income of \$350,000” example, the optimal allocation would be \$250,000 to Qualified Income and \$100,000 to Salary, achieving the maximum deduction of \$32,500 and tax savings of \$13,680, an additional \$2,400 savings.

Once Total Income reaches \$415,000 (\$207,500 single) and above, the optimized allocation will yield a maximum \$59,285 deduction. No deduction is available for Qualified Income over that maximum when Total Income is in excess of \$415,000 (\$207,500 single).

S Corporation §199A Savings (Married):

Net Income	Salary ⁵	Savings ⁸
\$70,000	\$35,000	\$514
\$140,000	\$60,000	\$3,520
\$210,000	\$70,000	\$6,720
\$280,000	\$80,000	\$7,920
\$350,000	\$100,000	\$13,680
\$420,000	\$120,000	\$18,971

Limitation #2: Deduction Phased Out over \$315,000 on Specified Service Income.

Another major limitation to §199A is that the deduction is phased out completely for Net Income over \$315,000 (\$157,500 single) in a straight line over the next \$100,000 in Total Income (\$50,000 single), and no deduction is allowed at all if Total Income exceeds \$415,000 (\$207,500 single), for Qualified Income earned in specified service trades or businesses (a “**Specified Service**”). The TCJA defines those trades and businesses as including “any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.”¹²

Using our prior example of a married business owner, but with Specified Service Income of \$350,000 optimally split between \$250,000 in Qualified Income and \$100,000 in Salary, the amount available for the §199A deduction is calculated as follows:

Pre-adjustment Qualified Income deduction: 20% of \$250,000 = \$50,000

$$(\$415,000 \text{ minus } 350,000) / \$100,000 \\ = 65\% \text{ of } §199A \text{ deduction remaining}$$

Qualified Income deduction is limited to 65% of \$50,000, which equals \$32,500.

For married Specified Service business owners, once Total Income reaches and exceeds \$415,000 (\$207,500 single), the §199A deduction completely disappears, even for the first \$315,000 of Total Income.

S Corporation §199A Savings

For Specified Service Income (Married):

Net Income	Salary ⁵	Savings ⁸
\$70,000	\$35,000	\$514
\$140,000	\$60,000	\$3,520
\$210,000	\$70,000	\$6,720
\$280,000	\$80,000	\$7,920
\$350,000	\$100,000	\$8,892
\$420,000	\$120,000	\$0

Sole Proprietorship vs. S Corporation under §199A.

The run-up to the TCJA included a lot of discussion in Congress about the Qualified Income deduction applying to any business other than an ordinary “C” corporation: the so-called “pass-through” entities such as S corporations, partnerships, LLCs disregarded for tax purposes or taxed as S corporations, and sole proprietorships. These entities don’t pay any federal corporate/entity level income tax, so

the tax burden effectively “passes through” the entity itself and is applied only at the personal level. In comparison, ordinary “C” corporations are double taxed on profits paid out to the business owner: first as Net Income at the corporate level, then again as a “dividend” at the personal level. In fact, the introductory text of §199A reflects that intention: “In the case of a taxpayer other than a corporation, there shall be allowed as a deduction....” Therefore, one would expect that all pass-through entities would be eligible for the same Qualified Income deduction.

However, other language in §199A, when read in combination with other sections of the IRC, ends up requiring disregarded LLCs and sole proprietorships to make their Qualified Income deduction calculations differently than calculations made by S corporations or partnerships. The difference lays in the fact that Net Income for these other pass-through entities is deemed to not include Salary, so the entire Net Income appears to be treated as Qualified Income.

Initially, this looks like a good thing for sole proprietorships. For example, a sole proprietorship with \$315,000 in Net Income and Total Income would also have \$315,000 in Qualified Income and Total Income, and therefore be entitled to a §199A deduction of 20% of its \$315,000 Qualified Income, or \$63,000. This generates an additional \$4,320 in §199A savings than under an S corporation paying \$90,000 in “reasonable” Salary.

Unfortunately, a business owner’s “self-employment income” from a sole proprietorship is considered Salary for payroll tax purposes. Therefore, all \$315,000 of the Net Income is treated as Salary and subject to \$21,500 in payroll tax.¹³ The owner of a sole proprietorship ends up paying \$5,280 more in payroll and income taxes than the owner of an S corporation paying \$90,000 in “reasonable” Salary.

In fact, the sole proprietorship’s situation could get even worse. An IRS auditor could point out (quite fairly) that because none of a sole proprietorship’s Net Income is considered Salary, and the §199A deduction is limited to no more than “50% of Salary,” the §199A deduction is completely eliminated when Total Income exceeds \$315,000. Under this scenario, the sole proprietorship ends up in the worst of both worlds: paying payroll tax on its entire Net Income, but not being eligible for *any* §199A deduction.¹⁴ That’s not fair, but that’s exactly how a quota-driven IRS employee could approach the situation.¹⁵

Ultimately, the Treasury Department may recognize this conflict between text and congressional intent, and fix the discrepancy at the regulatory level to allow other pass-through entities to allocate a reasonable portion of Net Income to Salary and the remainder to Profits, just like S

corporations. Then again, you can’t count on Treasury (or Congress) making the fix. For the business owner, choosing the S corporation over a sole proprietorship is the obvious choice. ■

Robert W. Olson, Jr., is an attorney in Santa Barbara, focusing on business and corporate law, commercial real estate, estate planning, and related tax issues.

ENDNOTES

- 1 © 2018. All rights reserved
- 2 The term “S corporation” includes both corporations and LLCs, either of which have made the “S” election available under IRS Form 2553 and IRC §1362(b).
- 3 The proper legal terms are “wages” for Salary and “distributions” for Profits. “Wages” and “distributions” are defined at IRC §301(c)(1), and earned income is defined at IRC §401(c)(2). I chose to use more user-friendly terms since this audience has very few accountants or tax attorneys.
- 4 The payroll tax applies to corporations that pay Salary to employees, including that paid to stockholders for services provided to the corporation. The payroll tax is called “self-employment tax” for sole proprietorships that cannot pay Salary to the owner/employee under current law.
- 5 Before you get all excited about reducing Salary to \$0, be advised that this technique guarantees an IRS audit. Salary must be considered “reasonable” to justify allocating the balance of Net Income to Profits. As to what constitutes reasonable Salary, IRS publications and a few federal court opinions provide general guidance, but there is no definitive method to calculate what percentage of your Net Income is reasonably allocated to Salary. Please discuss the specifics of your situation with your accountant or tax attorney.
- 6 Salary figures are for illustration purposes only and are not posited as “reasonable.” Check with your accountant or tax attorney for specific guidance.
- 7 Savings based on assumed federal payroll tax of 15.3% up to \$128,400, 2.9% from \$128,400 up to \$250,000 (\$200,000 single), and 3.8% over \$250,000 (\$200,000 single), and includes California’s 1.5% tax on S corporation Profits over \$53,333, and 50% deductibility of self-employment taxes for sole proprietorships.
- 8 The full text of §199A can be found at <https://www.law.cornell.edu/uscode/text/26/199A>.
- 9 Assumes no other income and using 2018 federal tax brackets.
- 10 Yes, getting married is great tax planning.
- 11 For purposes of this calculation, Salary includes that paid to S corporation employees, not just to the business owner. There is a very favorable alternative limitation available for businesses heavily invested in employees, equipment, and/or real property: 25% of Salary plus 2.5% of the unadjusted basis of all “qualified property.” Real estate investors will love this alternative.
- 12 See IRC §§199A(d)(2)(A) and 1202(e)(3)(A). The extent to which Specified Service business owners may get around the “specified services” limitation is the subject of another article.
- 13 See IRC §§1401, 1402(b), 1402(d), and 3121(a).
- 14 The same argument would apply to LLCs not electing S corporation treatment. A partnership’s “guaranteed payments” are considered Salary for §199A calculation purposes.
- 15 Many tax professionals theorize that IRS agents have an audit quota and IRS auditors have a collections quota.