When Once Is Not Enough: Double Taxation of S Corporations

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When a corporation is originally chartered by a state, it exists as a “C” corporation. A C corporation is a separate entity that is taxed under subchapter C of the Internal Revenue Code. The shareholders of a C corporation are only taxed on what they receive from the corporation. When the corporation distributes its after-tax profits to shareholders in the form of dividends, the shareholders pay taxes on the dividend income even though the corporation has already paid corporate taxes on the same income. This is the “double taxation” problem that is commonly sought to be avoided by electing to be taxed under subchapter S of the Code. A so-called “S” corporation does not pay an entity-level tax on its earnings. Rather, those earnings “pass-through” to the owners. The problem is that federal double taxation is not the only double-tax trap that taxpayers may need to avoid.

In New York City, for example, the General Corporation Tax is imposed on all corporations at a rate of 8.85%. NYC does not recognize federal or New York State S corporation elections, and so S corporations are subject to the General Corporation Tax. For NYC-resident shareholders of S corporations, this can produce a situation where income is taxed twice: once at the corporate level, and then again at the shareholder level on the individual income tax return, with no credit or deduction available to offset or ameliorate the double taxation problem.

A C corporation becomes an S corporation only when special pass-through tax treatment is sought by electing S status with the IRS. While most states and cities honor a valid federal S election for pass-through taxation, a few states, like New York and New Jersey, require the filing of a separate state election. More problematic is that some states and cities do not even extend pass-through taxation status. These include the District of Columbia, New Hampshire, Tennessee, Texas and New York City. In a state like Texas, double taxation is not a problem because Texas does not impose an individual income tax, so, while a tax is paid by the corporation, there is no secondary tax at the shareholder level. But in other jurisdictions, like New York City, the double-taxation problem continues to persist.

Ways to Reduce or Eliminate Double Taxation

One solution may be to structure the business as a limited liability company. However, while the profits of an LLC are not subject to New York’s 8.85% General Corporation Tax (because the LLC is not a corporation), the profits are subject to a 4% Unincorporated Business Tax. The NYC Unincorporated Business Tax is an income tax that anyone operating an unincorporated business in NYC must pay in addition to regular individual federal, state and city income taxes. The good news is that, unlike the General Corporation Tax, a credit is available to eliminate or reduce double taxation; the bad news is that the amount of the credit is significantly reduced for taxpayers with NYC taxable incomes of $142,000 or more in 2012.

Another potential pitfall of the LLC structure is that the LLC’s profits will be subject to self-employment tax, which is the employer’s portion of Social Security and Medicare taxes. This tax is not deductible for federal income tax purposes, and it is not subject to the double taxation that applies to S corporations.

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Security and Medicare taxes, imposed on sole proprietors and other self-employed persons. It is identical to the Social Security tax withheld from the pay of most workers, but because the self-employed must contribute both the employer and the employee portions of the Social Security tax, they pay at a rate of 15.3% of net earnings (temporarily lowered to 13.3% for 2012). Fortunately, half of the self-employment tax, i.e., the employer-equivalent portion, is allowed as a deduction against income on the individual’s income tax return.

S corporations are often touted as a vehicle to reduce self-employment taxes by passing out the majority of profits to shareholders as non-wage distributions exempt from Social Security and Medicare taxes. However, decades of abuse have spurred rules requiring owner-employees of an S corporation to be paid salaries of a “reasonable amount,” thereby reducing the amount that can pass free of Social Security and Medicare taxes.

If the owner-employee of the S corporation is already receiving a salary in excess of the maximum amount subject to the Social Security tax ($110,100 in 2012), another solution is to pay a year-end salary bonus equal to the net profit of the company to date. The additional wage income will be subject to Medicare tax because the Medicare tax is levied on all self-employment income without limit (unlike the Social Security tax which applies to earnings up to an annual ceiling). The company will expense the additional wage income, thereby reducing the net profit of the S corporation to zero, leaving nothing for NYC to tax at the corporate level. For personal income tax purposes, the amount of income will be the same; there will only be a change in the character of the income from S corporation income to wage income. And while the change in character will increase the portion of income subject to Medicare taxes, the additional Medicare tax of 2.9% will still be much less than the tax of 8.85% under the General Corporation Tax. This is also true if the comparison is with the tax rate applicable to the LLC structure that can reach 6.9% (the 4% Unincorporated Business Tax rate plus the 2.9% Medicare tax rate).

Beginning in 2013, the Medicare tax on wages and self-employment income will increase to 3.8% on income above certain thresholds, and it will apply for the first time to some investment income. And, with state governments constantly changing tax rates and rules, it is wise to consult your tax or legal advisor on an ongoing basis to keep abreast of the changes in the law and how they may affect you.

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