Still Going S? Repeal of the ACA May Limit Benefits of S Corporations

Since the 2010 passage of the Affordable Care Act (the ACA), the use of S corporations has seen a steady increase in popularity among tax advisers, despite the fact that conventional wisdom provides that S corporations offer less operational flexibility than partnerships.

Now that the ACA's tax provisions are being targeted by both the Trump Administration and the Republican controlled Congress, the use of S corporations for small business planning in place of LLCs taxed as partnerships needs to be reexamined. This article briefly explains why your tax adviser may be recommending that you use an S corporation to support your business operations, and what impact the repeal of the ACA may have on this decision.

Overview
Earnings from a business that has elected to be taxed under Subchapter S of the Internal Revenue Code (an S corporation) are not subject to separate entity-level income taxes. Instead, shareholders are directly taxed on their allocable share of pass-through income which results in a series of stock basis adjustments. Distributions reduce the stock basis of shareholders, but are otherwise tax-free. To this extent, Subchapter S and Subchapter K (which deals with the taxation of partnerships) are essentially the same. However, S corporations suffer from additional limitations that make them less accommodating for a variety of businesses.

S Corporation Limitations
S corporations are subject to unique ownership restrictions and lack the significant flexibility partnerships have in allocating income. Moreover, failure to adhere to the S corporation rules can result in the revocation of a corporation's S election.

S corporations are not permitted to have more than 100 shareholders, and only U.S. individuals, certain types of trusts, estates, and charitable organizations are able to own shares. S corporations may only have one class of stock in which all shares must confer equal economic rights. Consequently, common partnership conventions such as the issuance of preferred units and profits interests, and the use of special or shifting allocations, are not possible. Lastly, S corporations do not automatically give shareholders basis credit for their pro rata share of the corporation's liabilities.

Altogether, these rules make S corporations unsuitable for most real estate investments, private equity funds, and tax-credit deals.

S Corporation Advantages
The most common reason for forming an S corporation currently is the opportunity to reduce the 2.9% Medicare tax, along with the .9% Medicare surtax and the 3.8% net investment income tax (NIIT). Both the Medicare surtax and the NIIT are part of the ACA. For businesses generating large amounts of income, organizing as an S corporation can offer tangible marginal tax rate relief.

The IRS has generally taken the position that partners, or members of LLCs taxed as partnerships, cannot be employees for payroll tax purposes. Partners actively involved in operations are therefore treated as self-employed, and must pay both portions of employer and employee payroll taxes (FICA and the 1.45% Medicare) on their shares of ordinary income. An additional .9% Medicare surtax is assessed on high earners. Critically, Medicare taxes do not have an earnings cap.

In contrast, with respect to an S corporation, FICA and Medicare are applicable only to payments made to shareholders as an employee of the S corporation. For profitable S corporations, the amount of income over reasonable compensation for S corporation owner/employees will therefore escape Medicare tax.

In contrast to payroll taxes, the NIIT applies to passive activity items such as gains, interest, rentals, capital gains, royalties, and dividends, but not earnings from a trade or business in which the taxpayer materially participates.

Working together, Medicare and the NIIT are designed to impose a 3.8% tax on either passive or active income. Active income from an S corporation, however, is not subject to either Medicare or the NIIT, creating an opportunity for rate relief.

Impact of ACA Repeal
Repealing the ACA will obviously reduce the top marginal rate benefit enjoyed by S corporation shareholders when compared to entities taxed as partnerships from 3.8% to 2.9%. Assuming tax reform does not address the payroll tax disparity between partnerships and S corporations, planning for Medicare rate relief could still make sense. The question for owners is whether they anticipate generating enough income to make a 2.9% savings worthwhile considering the other limitations S corporations have.

Eliminating the NIIT will also benefit passive S corporation shareholders, but not relative to passive partnership investors.

Realistically, the repeal of the ACA is likely to have a far greater impact on healthcare than on the tax code. On the other hand, repealing the ACA's tax provisions are likely to be only a small part of any comprehensive tax reform proposal. Ultimately, owners will need to watch what Congress does carefully over the next year to make informed tax planning decisions.

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