

S OR C CORPORATION?

Maximize tax deductions by using both.

BY CAROLE C. FOOS, CPA, AND DAVID B. MANDELL, JD, MBA



Choosing the form and structure of your medical practice is an important decision. Most advisors to medical practices believe that avoiding potential double taxation makes the S Corporation the logical choice, but this conventional

wisdom overlooks the potential benefits a C Corporation can offer. If you want to explore ways to reduce unnecessary taxes without subjecting yourself to “double taxation” and learn how you can do this without having to change any of your insurance provider or Medicare provider numbers, this article is for you.

THE BASICS OF CORPORATIONS

First, let us assume that your practice is either an S or C Corporation. There is little reason to practice as a sole proprietorship or general partnership, because doing so can result in an unnecessary lawsuit risk. You also cannot take advantage of many valuable tax-deductible business expenses mentioned.

All businesses that incorporate are automatically C Corporations absent an election to become an S Corporation. Both S and C Corporations have separate tax identification numbers and are required to file tax returns with the federal and appropriate state tax agencies. Both entities have shareholders and can be created in any state in the country.

When a C Corporation earns profit, it must pay tax at the corporate level. Profit is defined as the difference between income and expenses. The compensation paid to physicians is deductible by the corporation on its tax return (and is therefore not taxable to the corporation).

The salary received by the owner is taxable to the owner as wages. After the C Corporation pays taxes, distributions of earnings already taxed at the corporate level can be paid to the physician-owners in the form of dividends. These would generally be taxed to the physician-owners as qualified dividends, thus leading to the double taxation of such earnings. This drawback is often overrated.

An S Corporation is also a separate entity that must file its own tax return. The S Corporation is often referred to as a *pass-through entity*. Rather than pay tax at the corporate level, all income and deductions pass through to the shareholders, and the shareholders must pay tax on any S Corporation income at their individual rates. Whether the income to an S Corporation is paid to the physician-owners as salary or as a distribution,

the federal or state income tax rates that will be applied to that income for the physician will not be affected. There is never any tax to the corporation, so there is no double taxation in an S Corporation.

DOUBLE TAXATION: MUCH ADO ABOUT NOTHING

Most physicians are under the impression that S and C Corporations have exactly the same benefits. Because the latter has a potential double taxation, most doctors and their advisors choose the S Corporation to avoid a potential problem. First, it is important to know that the double-taxation problem can be easily avoided by reducing practice profits to zero, or close to zero, at the end of the year with reasonable compensation and bonuses to the physician owner. Second, the increased benefits that the C Corporation offers medical practices can far outweigh the time required to zero out a C Corporation.

DEDUCTIBLE BENEFITS OF A C CORPORATION

A C Corporation can be the right choice for many small entities because of the deductions it allows. The corporate deduction for fringe benefits paid to employees is generally limited for shareholders who own more than 2% of an S Corporation. A C Corporation enjoys a full deduction for the cost of employees' (including owner employees) health insurance, group term life insurance of up to \$50,000 per employee, and even long-term



care premiums without regard to aged-based limitations. The C Corporation can also deduct the costs of a medical reimbursement plan. If a physician has a small corporation and a lot of medical expenses that are not covered by insurance, the corporation can establish a plan that makes all of those expenses tax deductible. Fringe benefits such as vehicles and public transportation passes provided by the employer are also deductible.

In contrast, the health insurance paid by an S Corporation for a shareholder of more than 2% is not deductible by the corporation. The shareholder generally must take a self-employed health insurance deduction on his or her personal return. Long-term care premiums paid through an S Corporation also are not deductible by the corporation with regard to these shareholders. The shareholders, in deducting these long-term care premiums personally, are subject to the age-based limitations.

LOWER TAX RATES FOR C CORPORATIONS

C Corporations enjoy their own graduated rates. The first \$50,000 of taxable income in the C Corporation is taxed at a 15% federal rate versus the top marginal rate of the shareholder (currently 39.6%) that the owner of an S Corporation will be taxed. Even if the owner of a C Corporation forgot to zero out the corporation and left \$50,000 in the entity, the corporate tax would be only \$7,500. A dividend of the remaining \$42,500 would only be taxed at a rate of 23.5%, resulting in taxes of another \$10,115 and leaving \$32,385 (or 64.8%). If that \$50,000 had been in an S Corporation and the owner had an annual income over \$450,000, the federal tax rate would have been 39.6% (or \$19,800). In this example, leaving \$50,000 to be taxed in a C Corporation would actually have saved the owner over \$2,000 in taxes.

Personal service corporations (PSCs) such as attorneys, doctors, and accountants do not receive the benefit of these graduated rates, because PSCs are taxed at a flat 35% rate. Therefore, PSCs do not enjoy the same benefits of the graduated C Corporation rate structure that other types of businesses will enjoy. PSCs can take advantage of the full section 179 expense deduction in writing off furniture and equipment in the year of purchase. C Corporations are afforded their own section 179

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deduction limitation. Shareholders of an S Corporation must accumulate the section 179 deduction among each of their pass-through entities; thus, they could be limited in a given year.

If the practice has rental activity, a C Corporation that is not a PSC has the advantage of using rental losses to offset operating income. Shareholders of an S Corporation must treat rental losses as a passive activity subject to the passive loss and at-risk rules.

S CORPORATIONS MAY BECOME OBSOLETE

Discussions in Congress in recent years could have limited much of the tax benefit of an S Corporation for service professionals. The benefit of an S Corporation at issue is the ability for doctor-owners to save Medicare taxes on their distributions as opposed to their salaries. By paying themselves a "reasonable salary" and taking the remainder of their business income as distributions, physician-owners can save thousands of dollars each year in Medicare taxes. The proposal in Congress would have eliminated this benefit. This proposal seems to be raised every few years in Washington, thus far, without any traction.

WHY NOT USE BOTH?

Many practices can take advantage of both the C and the S Corporation by setting up two distinct entities to operate different aspects of the practice. The S Corporation could be used for the operating side of the practice (the professional practice of medicine), while the C Corporation could be used for managerial functions (billing and administration). In this way, the practice as a whole can take advantage of both the tax deductions afforded a C Corporation and the "flow through" advantages of an S Corporation. This may also provide some additional asset protection. As long as all formalities of incorporation are followed and there is compliance with rules for employee participation in all benefit plans, medical practices can take advantage of this dual corporate structure. ■



AT A GLANCE

- When used properly, S Corporations provide physicians with the ability to save on Medicare taxes.
- C Corporations provide physicians with the ability to use write-offs not available to S corporations.
- Sometimes, a corporate structure that uses both S and C corporation-taxed entities provides the greatest overall tax management.

Carole C. Foos, CPA

- principal and lead tax consultant, OJM Group, Cincinnati, Ohio
- (877) 656-4362; mandell@ojmgroup.com

David B. Mandell, JD, MBA

- former attorney and author
- principal, OJM Group, Cincinnati, Ohio
- (877) 656-4362; mandell@ojmgroup.com