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Potential New Taxation for S Corporation Shareholders

The latest Congressional session has seen the introduction of a new bill in the House of Representatives that could lead to costly new taxes for shareholders of S Corporations.

Often small businesses that incorporate also make what's known as a "subchapter S" election, a federal tax election that allows these "S Corporations" to "pass-through" corporate income, losses, deductions and credits to their shareholders. In other words, the shareholders pay the applicable federal tax at their individual tax rates rather than the corporation except in some rare instances such as built-in gains and passive income.

Currently, the distributive income reported by the shareholders is not subject to payroll taxes. However, a new bill in the House of Representatives, H.R.4213 – American Jobs and Closing Tax Loopholes Act of 2010, would change that and make this distributive income, self employment income to certain shareholders.

Under a provision in the prospective law, the "distribution of earnings" made by an S Corporation to a shareholder who "provides substantial services with respect to the professional service business" would be subject to a 12.4% FICA tax as well as a 2.9% Medicare tax making for a potential combined total of 15.3% self employment tax. However, it is worth noting that the FICA portion of the tax will only apply to the first \$106,800 of combined wages, tips and net earnings including S Corporation income distributions.

A "professional service business" is a business with substantially all of its services in the fields of Health, Law, Engineering, Architecture, Accounting, Actuarial Science, Performing Arts, Consulting, Athletics, Investment Advice or Management, Lobbying or Brokerage Services. In other code sections, management services were also included as a personal service corporation. It is unclear if this will be included under the consulting area, or excluded.

The Senate has already tentatively adjusted the House version of the provision so that distributed income would only be taxable if 80% or more of the S Corporation's earnings are attributed to the skill and reputation of three or fewer of its shareholders.

For now, these new taxes are only applicable for S Corporations in a "professional service business". However, shareholders of S Corporations in any service business could be next.

If you have any questions regarding this potential tax threat for shareholders of S Corporations, do not hesitate to contact your trusted advisor at Lane Gorman Trubitt, LLP for all the latest information.