THE HIGH COST OF S-CORPORATION SAVINGS

True, an S corporation doesn't pay federal income taxes. But it puts a squeeze on doctors in other ways.

By David J. Schiller, J.D.

You may have heard that tax reform now makes it worthwhile to transform your professional corporation into an S corporation. Don't believe it. And don't do it—at least not without a very careful look before you leap.

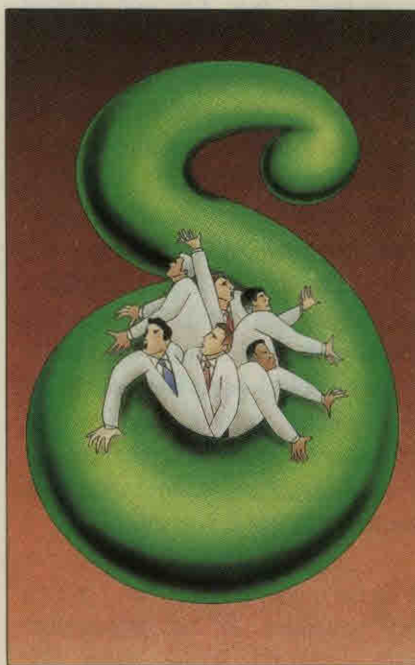
Proponents claim an S corporation has two tax advantages over a conventional corporation:

▶ The S corporation eliminates double taxation on current income.

▶ It can also eliminate double taxation on the sale of assets.

When you look closely at the tax rules, however, you find that you can avoid most of the double taxation without converting your corporation from C to S status. (C and S corporations are both named for the sections of the Internal Revenue Code that cover them.)

Other things being equal, it's better to have a C corporation. One major reason: A C corporation can deduct the cost of fringe benefits. An S corporation can't, and you'll owe personal income tax on the value of the insurance premiums that pay for the benefits it provides you.



Fringe-benefit deductions are a big plus for C corporations. Your health insurance may cost you between $3,000 and $4,000 a year, and your disability insurance another $3,000. Perhaps you also benefit from group term-life insurance. These add up to hefty deductions for a C corporation, and if you switch to an S corporation, they'll be significant additions to your taxable income.

Double income taxation. The great attraction of an S corporation is that it doesn't pay income taxes. It's treated like a partnership: Its earnings pass directly through to the shareholders, who pay tax on them as personal income.

The earnings of a C corporation can be taxed twice. If it earns more than its expenses (which include the compensation it pays you), it pays tax on the undistributed earnings at the special flat rate for personal-service corporations, 34 percent. When the after-tax remainder is passed on to you, that's considered a dividend, and you pay income tax on it again, this time in your own 28 or 33 percent bracket.

But it's easy enough for your corporation to

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keep its C status without subjecting you to a double tax. Simply make sure it has no undistributed earnings at year end. You can take a higher monthly salary, increase contributions to your retirement plan up to its maximum, or pay yourself a bonus at year end. Just be sure you cut the check by the last day of your fiscal year.

Some physicians fear that a big bonus from a C corporation may expose them to Internal Revenue Service charges of unreasonable compensation. I've seen this happen only once in the 300 practices I handle, and that case involved a neurosurgeon who'd given himself a $2 million bonus, although salaried associates had done most of the work. Most doctors don't face such temptations.

Asset sales. You can sell your practice in two ways: either by liquidating the corporation—selling off its assets—or by selling the shares in the corporation itself.

If you liquidate after 10 years in S status, tax reform exempts the corporation from paying tax on the appreciation of its assets up to the moment of liquidation. You're taxed only once: when you get the money. The C corporation itself is taxed on the appreciation when the assets are sold; you pay tax again when what's left is paid out to you—another kind of double taxation.

So switching to an S corporation may seem important if you expect to sell your practice a decade hence. But most practices have few highly appreciated assets, unless the corporation owns real estate or highly capitalized equipment for such specialties as ophthalmology or radiology.

Whatever your practice is worth, you don't have to convert to S status to avoid the tax on assets when you sell. You can avoid double taxation in other ways. For instance, you might bring in a junior associate and have him buy you out over a few years. He'd buy the stock in the corporation, which would continue to hold the assets and therefore would owe no tax on them.

Or you can liquidate, but minimize the value of the corporation's taxable assets. To do that, you might get part of the value of your practice as compensation for continuing consulting work to the physician who buys it, part for signing a restrictive covenant promising not to compete with him by practicing in the area. Both of those payments usually come to you over several years, which may provide a further tax advantage. Only a few hard assets and the good will would be left to be taxed when you finally liquidated the corporation. The good will would be worth relatively little. That may depress you, but the lower taxes will be good for you financially.

Receivables. When liquidated, a C corporation also pays a tax on the accounts receivable. Advocates of conversion to S status claim that the 1988 tax act enables you to avoid the tax on receivables. One way is to transfer them to the doctors who performed the services that earned them; another is to compensate those doctors in advance for the anticipated earnings.

There's no need to convert to S status; the C corporation can do the same thing. But with either type, you can't sell Medicare receivables if they're in the corporation's name. And you probably won't want to give salaried associates the full amount of the receivables they've earned.

If you stay in C status, the solution is simple: Don't liquidate the corporation all at once. Keep it alive to collect the receivables and pay them to you as ongoing or deferred compensation. Sell the other parts of the practice as outlined above.

These reasons for being skeptical about S status apply only to your medical practice. A sideline venture whose underlying asset is real estate should be an S corporation or a limited partnership from the start. This is also true of a health venture such as a walk-in clinic or a magnetic resonance imaging center that owns the land it's built on. By the time you sell your interest, the assets are apt to have appreciated considerably. In that case, double taxation from a C corporation would cost you more than the deduction on your fringe benefits is worth. ■