"S" or "C" Corporations? Maximize Tax Deductions by Using Both!

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Choosing the form and structure of one's medical practice is an important decision. Most advisors to medical practices believe that the avoidance of potential double taxation makes the S Corporation the logical choice. 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 would like to see how you can do this without having to change any of your insurance provider or Medicare provider numbers, this article is ideal for you.

The Basics of Corporations

First, let's assume that your practice is either an S or C Corporation. There is NO reason to practice as a sole proprietorship or general partnership. This results in unnecessary lawsuit risk, in addition to the inability to take advantage of many valuable tax-deductible business expenses mentioned in this article. To learn more about the asset protection benefits of corporations, order our book or read our articles at www.kenvanway.com.

Second, we need to compare and contrast C Corporations and S Corporations. All businesses that incorporate are automatically C Corporations absent an election to become an S Corporation. Both S and C Corporations have separate tax id numbers and are required to file tax returned with the federal and appropriate state tax agencies. Both entities have shareholders. Both entities 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 the difference between income and expenses. Compensation paid to physicians, as long as it is reasonable, 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. As you will see below, this drawback is often overrated.

An S Corporation is also a separate entity that must file its own tax return. However, the S Corporation is often referred to as a "pass through" entity. Rather than paying tax at the corporate level, all income and deductions pass through to the shareholders and the shareholders must pay tax on any S Corp income at their individual rates. Whether the income to an S Corp is paid to the physician owners as salary or as a distribution will not impact the federal or state

income tax rates that will be applied to that income for the physician. There is never any tax to the corporation, therefore there is no "double taxation" in an S Corporation.

Double Taxation – Much Ado About Nothing

Mistakenly, most physicians think of S and C Corporations as having exactly the same benefits. Since the C Corporation has a potential double taxation, most doctors and their advisors elect to make an S election to avoid one more potential problem. First, the double taxation problem can be easily avoided by reducing practice profits to zero, or close to zero, at the end of the year. Second, after you review the next section, you will see that the increased benefits the C Corporation offers medical practices, you will see that the cost (in time, not money) of zeroing out a C Corporation is far outweighed by the benefits.

Additional Deductible Benefits of a C Corporation

Contrary to much "conventional wisdom," 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 owning more than 2% of an S Corporation. However, 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 one has a small corporation and a lot of medical expenses that aren't covered by insurance, the corporation can establish a plan that results in all of those expenses being tax deductible. Fringe benefits such as employer provided vehicles and public transportation passes are also deductible.

In contrast, health insurance paid by an S Corporation for a more than 2% shareholder is not deductible by the corporation. The shareholder must generally take a self-employed health insurance deduction on his personal return. Long term care premiums paid through an S Corporation are also not deductible with regard to these shareholders. The shareholders, in deducting them 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 35%) 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 15% – resulting in taxes of another $6,375 – leaving $36,125 (or 72.2%). If that 50% had been in an S Corporation and the owner had annual income over $300,000, the federal tax rate would have been 35% (or $17,500). In this example, leaving $50,000 to be taxed in a C Corporation would actually have SAVED the owner over $3,600 in taxes!

Personal service corporations (PSC's), such as attorneys, doctors and accountants, do not receive the benefit of these graduated rates since PSC's are taxed at a flat 35% rate. Therefore, PSC's do not enjoy the same benefits of the graduated C Corporation rate structure that other types of businesses will enjoy. However, PSC's 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 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 which 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.

Get the Best of Both Worlds – Why Not Use Both?

Many practices can take advantage of both the C Corporation and the S Corporation by setting up two distinct entities to operate different aspects of their practice. Perhaps the S Corporation will be used for the operating side of the practice (professional practice of medicine) while the C Corporation will be used for management 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, as well as compliance with rules for employee participation in all benefit plans, medical practices can benefit from this "dual" corporate structure.

The information contained in this article is general in nature and should not be acted upon in your specific circumstances without further details and/or professional advice. Contact your personal tax advisor for specific advice related to your tax situation.

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