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## **RE: 2011 S Corporation Salary Proposed Rule Changes**

Dear S Corporation Client,

Section 413 of House Resolution 4213 passed on May 28 (in a vote of 215-204) addresses the issue of salaries for S corporation owners. One advantage of S corporations has been small salaries and large distributions for their owners.

S corporation profits flow through to the owners' individual income tax returns as ordinary income which is exempt from self-employment tax. A few years ago, Treasury inspectors found massive tax avoidance in this area. More than 35,000 one-owner S corporations with profits of \$100,000 or more paid no payroll taxes on the profits because owners didn't take salaries. Ditto for owners of about 40,000 S corps with profits in the \$50,000 - \$100,000 range. So tax writers decided to take action to end this abuse.

### This ends one advantage of choosing S status for small service businesses

Section 413 of the bill addresses employment tax treatment of professional services businesses. Specifically, **effective January 1, 2011**, it imposes self-employment tax on S corp distributive income that meets the following two tests:

- The corporation is engaged in a "professional services business" (defined as "a trade or business, substantially all of the activities of which involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services") and
- The principal asset of the business is the "reputation or skill" of three or fewer employees.

No exception will be allowed for amounts left in the firm for working capital, at least for small professional service S firms. Income passed through to owners of larger S service firms or S corporations that aren't in professional service fields, such as manufacturers, will continue to be exempt from self-employment tax.

Of course, the new rules won't affect S corporations operating outside the professional services arena. S corporations still offer advantages besides minimizing self-employment tax. For example, they dramatically lower audit odds relative to filing Schedule C.

We will keep you posted as we learn the details of this new law.

- tax services
- accounting
- estate and financial planning