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Should I Elect to Be Taxed as an S Corporation on My Recent Acquisition or Start-Up?

There are many important business decisions to be made in the first few months of a practice acquisition or start-up. A common one revolves around the IRS election to be taxed as an S Corporation. The election's main benefit to a company is that company profits are not subject to self-employment tax as they would be under a partnership or single member LLC structure. Most mature practices eventually make the S election with the IRS and operate this way for the rest of their economic life; however, the initial timing of this election is very important.

There are a few disadvantages to making this election too early in the practice life cycle.

1. **Self-employed losses:** A very common situation in practice transitions is a 1099 associate becoming an owner of a practice. Prior to buying the practice, the associate likely had significant self-employment tax from 1099 earnings. Losses generated from a partnership or single-member LLC are self-employment losses, which offset self-employment taxes from any outside self-employed income. As an example, an associate with $100,000 of 1099 earnings purchases a practice on October 1. The up-front costs, depreciation, and other expenditures make it unlikely the new practice will show net income in 2018. This loss being generated is expected to be $30,000. Under a single-member LLC or partnership structure, self-employment tax will only be due on $70,000 ($100,000 minus $30,000), saving the practice owner an estimated $4,590 in self-employment tax! Had the purchasing doctor elected to be taxed as an S Corporation in 2018 for the new practice, the $30,000 loss would not have been considered a self-employed loss, effectively costing the owner $4,590 in additional taxes. Practices normally should not make an S election until reaching certain thresholds of profitability.
2. **Basis Issues:** Taxpayers can claim losses from a company they own to the extent they have positive basis in that company. Taxpayers typically get basis in a company in one of 3 ways: making capital contributions, showing taxable income, or signing onto company debt with a personal guarantee. S-Corporation owners do not receive basis consideration for signing onto company debt. Conversely, owners in a partnership or single member LLC attain basis in a company by signing onto company debt with a personal guarantee.
3. **Additional Tax Return must be filed:** S-Corporations file a separate tax return unlike a single-member LLC which is included on the member's personal tax return. The filing cost should be considered when doing a cost-benefit analysis.
4. **Difficulty of adding owners:** S Corporations are not as flexible as partnerships when adding additional owners, nor can income be allocated unevenly between partners as seamlessly. If the addition of more owners is likely in the future, the entity's overall structure should be evaluated and the S election pros and cons weighed out carefully.

Practices should lean on experienced advisors when making major decisions related to their practice and ensure the decisions align with their long-term vision. The S-corporation decision can appear to be a no-brainer, but in reality the timing should be carefully planned or it can actually cost the owner hard earned tax dollars.

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