S Corps vs. PLLCs

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Many clients are still confused by the pros and cons of an LLC over an S Corporation. Part of this confusion comes from the fact that, as S Corp owners, the client has never really had to consider any other type of entity. Once the doctor enters into a partnership the issue around choice of entities becomes more acute. More confusion is caused when CPAs, or other advisors, who may understand some of the tax issues; may *not* understand the way partners get paid.

This is one of the complexities that occur between the tax planning and the business planning of dentistry.

S Corps have several advantages and you are probably familiar with some of them. Like all corporations, they allow the owner to limit his liability to the assets of the corporation. Plaintiffs *cannot* get to his personal assets (e.g. retirement accounts), unless the doctor is found liable for professional malpractice. A sole owner of an S Corp has quite a lot of freedom and doesn't have to worry about the double-taxation problems of an old-fashioned C Corp. There are still the usual regulatory hoops to jump through, when operating as an S Corp. and if these regulations are not observed you can lose the very advantage of having the corporation in the first place.

As I have mentioned in the past, the failure to observe all of the state, corporate, compliance requirements can cause the limited liability feature of your corporation when you need it most. A patient may slip and break a hip in your parking lot and if he obtains a judgment, he may attach your personal assets; not just the corporate assets.

This problem of corporate compliance can be avoided with some diligence; but S Corps become more of a problem when transitioning in a partner.

When an incoming partner purchases an interest in a practice organized as an S Corp, she is either buying stock in that corporation; or she is buying the assets. As I have said in the past, the vast majority of deals are done as asset sales; so that the buying doctor can get the maximum tax benefit from deducting her purchase price from income over time. At the same time, the seller in an asset sale has mostly capital gain treatment.

Notwithstanding technical provisions (IRC §338(h)) which allow the buyer to circumvent some of these problems when she is buying an 80%, or more, interest in the S Corp, the asset sale approach allows us to best maintain the win-win in the transition.

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Unfortunately, when executing an asset sale with an S Corp, we trigger some other, rather *nasty*, tax consequences. Most of these issues revolve around the recapture of depreciation and I have discussed this in previous missives; so I won't belabor the point here.

In contrast to the S Corp, the Limited Liability Company (LLC), or its professional variant, the PLLC, has a great deal more flexibility.

When a partner buys into a PLLC she automatically acquires basis in the underlying assets and is thus able to deduct her purchase price.

The PLLC is also much more flexible with regard to the compensation of partners. Partners can be compensated based upon their production and not strictly based upon their ownership percentages. This is a huge advantage to the PLLC; since properly drafted partnership agreements will have partner salaries driven by production, hours, or some other objective metric of effort.

The S Corp is very rigid on compensation and requires that owners be paid based upon their stock ownership percentages.

You may be asking why your CPA would ever argue in favor of the S Corp.

Twenty years ago an S Corp made a lot of sense for doctors. That's why most of you are S Corps. Thirty years ago it was C Corps. Things have changed a lot during the intervening years and now, any new doc would organize as a PLLC if he could. In some states (like California) doctors still can't practice as a PLLC.

The principal reason that your tax advisor may *still* recommend an S Corp, is a loophole in the Code relating to the Self Employment (SE) Tax. A **sole** owner, who pays himself a salary of $137,700 (the maximum salary for calculation of the Social Security portion (12.4%) of the SE Tax (15.3%)), can pay the rest of his compensation as a corporate distribution and thus avoid payment of the Medicare portion (2.9%) of the SE Tax.

In other words, if the doctor pays herself total comp of $400,000: $138,000 in salary and $262,000 as a corporate distribution, the latter portion avoids the Medicare tax of 2.9%; or $7,598.

This tax savings is the reason that many CPAs counsel their clients to use S Corps.

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This is an advantage; but it is in exchange for a lot more rigidity with an S Corp. There are additional costs related to an S Corp; such as the corporate compliance requirements mentioned above, annual state fees and accounting costs for filing a separate tax return (Form 1120S).

Naturally, each case has to be judged on its own facts and circumstances; so call me and ask if you are unsure.

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