How entity type affects tax planning for owner-employees

Come tax time, owner-employees face a variety of distinctive tax planning challenges, depending on whether their business is structured as a partnership, limited liability company (LLC) or corporation. Whether you're thinking about your 2016 filing or planning for 2017, it's important to be aware of the challenges that apply to your particular situation.

Partnerships and LLCs

If you're a partner in a partnership or a member of an LLC that has elected to be disregarded or treated as a partnership, the entity's income flows through to you (as does its deductions). And this income likely will be subject to self-employment taxes — even if the income isn't actually distributed to you. This means your employment tax liability typically doubles, because you must pay both the employee and employer portions of these taxes.

The employer portion of self-employment taxes paid (6.2% for Social Security tax and 1.45% for Medicare tax) is deductible above the line. Above-the-line deductions are particularly valuable because they reduce your adjusted gross income and modified adjusted gross income, which are the triggers for certain additional taxes and phaseouts of many tax breaks.

But flow-through income may not be subject to self-employment taxes if you're a limited partner or the LLC member equivalent. And be aware that flow-through income might be subject to the additional 0.9% Medicare tax on earned income or the 3.8% net investment income tax (NIIT), depending on the situation.

S and C corporations

For S corporations, even though the entity's income flows through to you for income tax purposes, only income you receive as salary is subject to employment taxes and, if applicable, the 0.9% Medicare tax. Keeping your salary relatively — but not unreasonably — low and increasing your distributions of company income (which generally isn't taxed at the corporate level or subject to employment taxes) can reduce these taxes. The 3.8% NIIT may also apply.

In the case of C corporations, the entity's income is taxed at the corporate level and only income you receive as salary is subject to employment taxes, and, if applicable, the 0.9% Medicare tax. Nevertheless, if the overall tax paid by both the corporation and you would be less, you may prefer to take more income as salary (which is deductible at the corporate level) as opposed to dividends (which aren't deductible at the corporate level, are taxed at the shareholder level and could be subject to the 3.8% NIIT).

Whether your entity is an S or a C corporation, tread carefully, however. The IRS remains on the lookout for misclassification of corporate payments to shareholder-employees. The penalties and additional tax liability can be costly.

As you can see, tax planning is extra important for owner-employees. Plus, tax law changes proposed by the President-elect and the Republican majority in Congress could affect tax treatment of your income in 2017.

Please contact Ceschini, CPAs at (631) 474-9400 for more information about this topic and other tax and business developments – such as new IRS regulations and court decisions.