



Small Business to be Hit Hard by New SECA Rules

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The Self Employment Contributions Act (SECA) tax law was enacted in 1954 that requires the owners of small businesses—such as S corporations, partnerships, and sole proprietorships—to pay a tax of 15.3 percent of their net income from self-employment to cover their own Social Security, Medicare, and Old Age Survivors and Disability Insurance (OASDI) costs.¹

To avoid paying the 15.3% tax, S Corporations have for years taken advantage of paying cash to shareholders as distributions instead of wages—not exactly what the IRS had in mind. Don't forget that S Corps also avoid corporate level income taxation too because that income is only taxed at the personal income tax level.

The IRS, of course, would like to tax as much of shareholder distributions as possible, so the House Ways and Means Committee has targeted this issue in H.R. 4213, Section 413, which specifically addresses S Corp personal services income. The SECA tax part of the bill is estimated to raise \$11.25 billion in revenue over 10 years and the Medicare tax would raise \$30 billion annually.

So what does this mean?

The IRS is stepping up audit efforts to identify these cases. They will be implementing a taxpayer education campaign, and the bill in congress will be targeting small personal and professional service businesses (performing artists, athletes, accountants, lawyers, actuaries, architects, consultants, engineers, health professionals, veterinarians, lobbyists, brokers, and investment advisors).

All professional service S-Corps with 3 or fewer professionally skilled individuals would see all pass-through net income taxed as SECA income, similar to sole proprietors who file Schedule C on their 1040 personal tax return.

The bill also aims to close a loophole that has allowed for the shifting of income to other family members to avoid SECA tax. Under this bill, the shareholder's share of income subject to SECA is increased by the share of family member shareholders who do not perform professional services.

¹ US Legal Definitions - <http://definitions.uslegal.com/s/self-employment-contributions-act/>

The Facts

1. Beginning in 2013 is the Medicare "contribution" of 3.8% on unearned income for people who earn over \$200,000 (\$250,000 if married) under the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152, Section 1402).
2. At the same time, preferable capital gains and dividend rates also increase upon expiration of the Tax Increases Prevention and Reconciliation Act (P.L. 109-222, Section 102), which extended the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27, Sections 301-303).
3. Long-term capital gains will increase from 15% to 20% in 2011 and qualified dividends will be taxed at ordinary income rates starting 2011.
4. Both capital gains and qualified dividends will increase another 3.8% in 2013 when the unearned income Medicare surtax in 2013 takes effect.
5. These taxes increases are on top of the 0.9% Medicare surtax on earned income that Congress has already passed under the Patient Protection and Affordable Care Act (P.L. 111-148, Section 9015) which also starts in 2013 with the same income thresholds. However, one-half of the SECA tax is still deductible from adjusted gross income under IRC 164(f).

Issues Not Addressed In the Bill

1. What if an S-Corp has a net loss? Does that entitle the owners to a SECA tax credit? This is not covered in this bill and Schedule C sole proprietors certainly do not receive anything like this.
2. What if the company has a banner year and brings in net income far exceeding each shareholder's reasonable compensation in terms of time and skill level. Shareholders would be taxed on the full amount of their pro rata net income under the bill.
3. Under IRS Revenue Ruling 74-44 the IRS can re-characterize S-Corp dividends as self-employment income, subject to SECA tax (Social Security wage base is \$106,800, Medicare unlimited). The IRS has routinely re-characterized dividends in the past so it is unclear why a new bill is needed to address taxpayer abuses and eliminate the ordinary compensation measurement altogether.

Possible Negative Affects

6. The higher tax rates could mean less money for investment at the small business level restricting growth.
7. More costly business & tax planning needed for small business owners usually only required by larger corporations.
8. With unemployment still at historical highs and expected to remain so for the near future this bill could stifle the job market even further.

How much of the \$11.25 billion in savings will really result is debatable. As the financial advising industry looks into this issue and realizes that there are other business-type entities, unaffected by the bill, that may be better to use, there could be a shift away from S Corps.

H.R. 4213, "The American Jobs and Closing Tax Loopholes Act of 2010", Section 413 (House Ways and Means Committee), passed the house as amended on 5/28/2010, effective for tax years after 12/31/2010. Portions of the bill concerning SECA would amend the Social Security Act, Section 211

<http://waysandmeans.house.gov/press/PRArticle.aspx?NewsID=11185>

Passed by house and awaiting review by the senate and the president to be signed into law.

http://waysandmeans.house.gov/media/pdf/111/HWC_711_xml.pdf

To contact your senator:

http://www.senate.gov/general/contact_information/senators_cfm.cfm

To contact your Representative:

<https://writerep.house.gov/writerep/welcome.shtml>

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