S-Corp SECA Tax Hike Catches Most Small Businesses Off-Guard

If you are a owner of a small business engaged in delivering professional services who has an adjusted gross income of under $200,000 and thought you were going to skate by the massive income tax hikes coming in 2011 and 2013, think again. Many business owners with salaries under $107,000 are about to see a significant increase in their taxes.

The Kiplinger Tax letter, May 28th, reported that the House just passed a SECA tax hike that will effect many S firm owners. The tax will make all dividends from service firms subject to SECA tax, starting next year.

This revenue-raising bombshell was passed by the House as they adjourned prior to the Memorial Day recess.

Hardest hit will be very small personal service S firms where the principal product is the reputation and skill of three or fewer workers. Owners of S firms that are partners in a service partnership will owe SECA tax on their entire profits, not just their salaries.

Currently, the tax is 15.3% of the first $106,800 in salaries and 2.9% above that. Now, the dividends of small S firms in these fields will be treated as if they are salary and subject to SECA tax. The companies effected are those engaged in accounting, law, health, actuarial science, engineering, architecture, lobbying, consulting, brokerage services, investment management, sports and the performing arts.

The change will end a popular SECA tax saver for personal service S firms: Taking a modest salary and receiving the rest of the profit as a dividend, which are not subject to SECA taxes. Those dividends are hit with income tax.

A few years ago, Treasury inspectors found massive tax avoidance in this area. More than 35,000 one-owner S companies with profits of $100,000 or more paid no payroll taxes on the profits because the owners didn't take a salary. It was the same for owners of about 40,000 S firms with profits in the $50,000-$100,000 range. So Congress decided to take action to end any possibility of gaming the system.

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