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Closing the “John Edwards” Loophole Helps, Not Hurts, Small Business

The tax extenders bill (H.R. 4213) currently pending in Congress contains a provision to close what is commonly known as the “John Edwards” loophole, which allows some shareholder-employees of “S corporations” to avoid paying the Medicare payroll tax on their earnings.¹ An amendment offered by Senators Olympia Snowe (R-ME) and Mike Enzi (R-WY) would remove this reform and preserve the loophole. This amendment should be rejected. Despite what these lawmakers may believe, closing this loophole will actually help most small businesses, which are currently subsidizing the minority who abuse it to avoid payroll taxes.

A Second Chance to Close (or at Least Reduce) the “John Edwards” Loophole

During the debate over health care reform, members of Congress realized a particularly unfair aspect of the Medicare tax: It entirely exempted investment income. The health care reform law closed this gaping hole in the Medicare tax by making it apply to most types of non-retirement income, not just wages. But there is still one strange exception, leaving one category of non-retirement income still not subject to the Medicare tax: certain “active” income from S corporations. H.R. 4213 would reduce, but not eliminate this exception.

An S corporation does not pay a corporate level tax. Instead, its income is “passed-through” to the individual shareholders who report the income on their personal income tax returns. If the shareholders are also employees, the S corporation pays them a salary and deducts that expense in calculating the income that is passed through to the shareholders. An individual’s share of S corporation is “active” if he or she “materially participates” in the business, but “passive” if he or she does not.

Whether the S corporation shareholders get income in the form of wages or as their share of the corporation’s profit, it is all subject to individual income tax. But only the wages are

¹ It is likely that the loophole is used mostly to avoid the Medicare tax, rather than the Social Security tax. The Social Security payroll tax only applies to wages up to a certain limit (which is \$106,800 this year). It is probably the case that most of the taxpayers who take advantage of this loophole earn so much that they cannot pretend to earn less than the Social Security cap. In fact, there is anecdotal evidence that when people with S corporations want to underestimate the amount of income that is wages in order to avoid payroll taxes, their tax advisers often suggest that they at least “pay” themselves wages up to the Social Security tax maximum so that they are “only” avoiding Medicare taxes.

subject to payroll taxes.² So, naturally, some people who own and work for an S corporation want to treat their earnings as non-wage corporate income in order to avoid payroll taxes.

If the health care reform law had simply made the Medicare tax apply to all non-retirement income, including all income from S corporations (which would have been logical and consistent) then this problem would have disappeared. Unfortunately, Congress left a loophole for “active” non-wage income of S corporations.

H.R. 4213 would not close the loophole entirely, but would reduce it by targeting those taxpayers who are most obviously abusing the tax laws.

How the Loophole Works

The most famous example of this abuse began when former presidential candidate John Edwards formed a corporation named John R. Edwards, P.A. (Professional Corporation) in North Carolina in June 1995. John Edwards was the only shareholder. The corporation filed an election with the Internal Revenue Service to be treated as an S corporation.

As a trial attorney, John Edwards paid himself \$600,000 in salary in 1996 and also received \$5 million as his share of the S corporation’s net income. That \$5 million (which Edwards earned as legal fees) was not subject to Medicare taxes, saving Edwards \$145,000.³

While any normal person would say that Edwards was being paid for his work, he told the IRS that most of the income generated was income from assets of the S corporation, including his famous name. In other words, Edwards claimed that he did not actually have to work to obtain most of his income, because clients came to him purely because of his fame as a star attorney.⁴

During the entire time Edwards was using his S corporation, it is reported that he took \$26 million out of the S corporation free of Medicare taxes, saving him \$754,000.⁵

Consider that John Edwards is only one attorney in a sea of professionals of all kinds—doctors, lawyers, consultants, lobbyists, architects—using this loophole and you can see why even partially limiting it is estimated to raise \$11.2 billion over ten years.

The way John Edwards used the loophole is pretty straightforward, but taxpayers have come up with lots of more complicated schemes to avoid the Medicare tax. For example, some professionals own only a small portion, say 5 percent, of their S corporation and their spouse

² The payroll taxes consist of the Social Security taxes of 12.4 percent on the first \$106,800 of wages and the hospital insurance (HI or Medicare) tax of 2.9 percent on all wages (3.8 percent on income above \$250,000). As explained in footnote 1, it is likely that the loophole is used mainly to avoid the Medicare tax.

³ Robert Novak, “The Edwards Loophole,” Townhall.com, March 1, 2004.
http://townhall.com/columnists/RobertNovak/2004/03/01/the_edwards_loophole

⁴ This is one of several paradoxical situations in which wealthy taxpayers put great effort into convincing the IRS that they are *not* working — and pay less taxes as a result.

⁵ Jay Heflin, “Small Corporations Line Up to Protest Closing ‘John Edwards’ Loophole,” *The Hill*, June 7, 2010.
<http://thehill.com/blogs/on-the-money/domestic-taxes/101645-small-corporation-line-up-to-protest-closing-edwards-tax-loophole>

owns the other 95 percent. The professional takes a small salary (or none at all) and most of the S corporation income goes to the spouse free of payroll taxes.

What the Pending Legislation Does

The S corporation provision in H.R. 4213 would not entirely eliminate this Medicare tax exemption. It would reduce it by targeting those taxpayers who are most obviously abusing the tax laws when they claim that their S corporation income is not wages.

The provision would make an S corporation's trade or business income (but not its rents, royalties, and capital gains income) subject to payroll taxes if it is allocated to a shareholder (or a member of the shareholder's family) and the shareholder performs substantial services for the S corporation. It would apply where the S corporation's principal claimed "asset" is the reputation and skill of three or fewer individual employee-owners, or if the S corporation's primary activity is the performance of professional services for a partnership of which it is a partner.

Think of a law firm made up of a single lawyer or an architectural firm made up of two or three architects. It's fairly obvious that any income such a firm generates is earned income, that is, compensation for the work of the lawyers/architects.

The bill has similar provisions to close the loophole for limited partners who perform professional services for the partnership. The new provision only applies to the performance of services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services.

Why the Provision Helps Small Business

There has been quite a hue and cry from some representatives of small businesses that this 2.9 percent tax will "cripple" small firms. So some lawmakers are calling for dropping the provision from the bill. In particular, Senators Snow and Enzi have introduced an amendment to strip this reform from the bill.

But their concern is misguided. Passing legislation to close this loophole will benefit the majority of small businesses. Most small businesses pay all of their taxes, including Medicare taxes on all of their personal service income. (The loophole is not allowed for partnerships or sole proprietorships.) When some small business owners avoid taxes, honest taxpayers make up the gap by paying higher taxes. Lawmakers who are concerned about the tax burden of small businesses need to do everything possible to close loopholes in the tax code so that all Americans pay their fair share.

Any attempts to modify the S corporation provision in H.R. 4213 should *strengthen* it rather than weaken it. Instead of just partially closing the loophole, Congress could close it completely by eliminating the exemption for active non-wage S corporation income from the Medicare tax. That way, whether taxpayers are sole proprietors, partners in partnerships, or shareholders in S corporations, and regardless of whether their income is active or passive, everyone will be paying their fair share of the Medicare tax.