



S-CORPORATION TAX BENEFITS

TAX BENEFIT #1:

INCOME SPLITTING & LOWER SELF EMPLOYMENT TAX

The way an S-Corporation saves money on self-employment tax (Social Security & Medicare tax for the self-employed) is by “splitting your income” into two groups:

- ❖ Salary - IRS Regulations require a reasonable salary for an Owner/employee who provides services to the corporation. This is how an S-Corp pays into the Social Security System.
- ❖ Net Profit - Revenue minus expenses

With this “income splitting,” you only pay the 15.3% self-employment tax on your salary.

Your extra money left over (net profit) is not subject to self-employment tax.

S-Corps are treated differently from a Sole Proprietorship or Partnership. Under these tax classifications, you pay self-employment tax on all your net income with no option to split your income and save money on self-employment tax.

Consequently then, the lower the reasonable salary, the higher the net profit, and the greater the self-employment tax savings. Income tax remains the same and is paid on both salary and net profit.

TAX BENEFIT #2:

ONE LEVEL OF TAX - NO DOUBLE TAXATION

An S-Corporation is a “pass through” entity where income tax on net profit is paid by the shareholders (owners) of the corporation.

There is no separate Federal income tax on corporate profit, and only a 1.5% California income tax (with a minimum of \$800).

In contrast, a C-Corporation will pay income tax on net profit and, if the profits are distributed to the shareholders (as a dividend), the dividend will also be taxed to the shareholder.

Lower Audit Risk

Historically S-Corporations have a significantly lower rate of audit than businesses organized as a sole proprietorship.

*Everything you
need to know*

TAX DISADVANTAGES #1:

LOWER SOCIAL SECURITY BENEFITS

Social Security benefits are based on your wages over your working life.

In an S-Corporation, that would be the salary you pay yourself and it does not include the distributions of profit you take out of the company.

Although you will be saving money on self-employment taxes by taking a lower salary now, you could be reducing your Social Security benefits in the future.

TAX DISADVANTAGES #2:

INCREASED ADMINISTRATIVE COSTS & TIME PER YEAR IF OUTSOURCED

- ❖ You must run payroll and you must file quarterly payroll returns (federal & state). \$450 - \$700*
- ❖ You must keep accurate books and a balance sheet. \$750 - \$1,800*
- ❖ You should hire an accountant to file your corporate tax return. \$750 - \$3,000*
- ❖ In California, there is a minimum tax of \$800 per year or 1.5% of net profit, whichever is higher.

*Costs vary based on complexity of client needs and level of services contracted.

HOW TO DETERMINE A REASONABLE SALARY

HERE ARE FACTORS TO CONSIDER

- Business profit available
- Experience, training, and certifications
- Duties and responsibilities
- Personal budget
- The time and effort you provide to the business
- How much you pay regular employees (if applicable)
- What similar businesses pay employees for similar service

As a rule of thumb, it is good to document how your time is spent in the business, and what the appropriate salary is for each of those activities. For example, you may spend 50% of your time on your core business, 25% on marketing, and 25% on customer service.

Visit two sites which list salaries such as [Salary.com](https://www.salary.com) & [Indeed.com](https://www.indeed.com).

Average them out. We recommend printing/saving your findings for good documentation.



S-CORPORATION SAVINGS

S-CORPORATION TAX SAVINGS EXAMPLE

Net Profit Before Income Splitting	\$150,000	
Reasonable Salary (Wage)	<u>(50,000)</u>	
Net Profit	100,000	
Self-Employment tax on \$150,000		\$19,939
Social Security & Medicare Tax on wage		(7,650)
Admin Costs		
Professional Fees – Payroll		(450)
Professional Fees - Tax Return		(750)
CA Income Tax (1.5% of \$100,000)		(1,500)
Decrease in QBI Deduction (22% tax bracket)		<u>(2,200)</u>
<i>Self-Employment Tax Savings</i>		<i>\$7,389</i>

On a net profit of \$150,000 before Income Split, your

Self-Employment Tax Savings is \$7,389.

YOUR CALCULATIONS HERE

STANDARD AUTO MILEAGE METHOD

- ❖ This method is generally for vehicles which have a low (less than 50%) business use.
- ❖ The owner/employee tracks business miles in a written log and submits the mileage to the corporation for reimbursement through an accountable reimbursement plan on no less than a quarterly basis.
- ❖ For 2022, the IRS approved maximum reimbursement rate is \$0.625 per mile.
- ❖ The owner/employee pays all actual vehicle expenses out of their personal account because the vehicle is personally owned.
- ❖ Reimbursement check is a deduction on the corporate tax return and is not taxable to the owner/employee.

Standard Mileage Method:

This method is best for vehicles with less than 50% business use.

ACTUAL AUTO EXPENSE METHOD

- ❖ Corporate-owned vehicle, cost of vehicle placed in corporate books.
- ❖ Used when business use percentage is high (70% or more).
- ❖ For vehicles between 50% - 70% business use, you would need to consider both methods to determine the greatest benefit.
- ❖ Mileage log is still required.
- ❖ All actual expenses paid by corporation including loan interest, lease payments, fuel, insurance, license & registration, and repairs.
- ❖ Tax accountant calculates vehicle depreciation at tax time.
- ❖ Owner/Employee tracks personal miles & adjustments are made to W-2 form to include income for personal use of vehicle (Tax accountant or payroll service can help calculate personal use income based on IRS approved methods).

Actual Expense Method:

This method has all actual expenses paid directly by the corporation, including license & registration fees.



S-CORPORATION DEDUCTIONS

HEALTH INSURANCE PREMIUMS

- ❖ Paid by corporation.
- ❖ Deducted by corporation as officer salary on Form 1120-S.
- ❖ Deducted by owner/officer as self-employed health insurance deduction on Form 1040 individual income tax return.
- ❖ Included in Box 1 of form W-2 as taxable wage.
- ❖ Not subject to Social Security or Medicare tax on W-2 in box 3 or box 5.
- ❖ Net effect is all health insurance is deducted by corporation, but each owner / officer is allocated their respective insurance costs through the W-2.
- ❖ Subsidies through Covered California are not allowed.

All health insurance premiums are paid by the corporation, and not subject to Social Security tax.

HOME OFFICE DEDUCTIONS

In an S-Corporation, if an owner employee officer allows the use of their home to conduct corporate business, the costs associated with the use of the “home office” should be reimbursed to the owner/employee officer on a regular basis (minimum quarterly basis) through an accountable expense reimbursement plan.

Housing Annual Cost:

Mortgage Interest	\$12,000	Home Office Example: <i>Office Square Footage: 200 sq. ft.</i> <i>Home Square Footage: 2,000 sq. ft.</i> <i>Ratio: 10%</i>	
Real Estate Tax	\$3,000		
Utilities	\$3,000		
Repairs / Maintenance	\$3,000		
Insurance	\$1,500		
HOA Fees	<u>\$3,000</u>		
	\$25,500		
	Monthly Cost / 12	\$2,125	
	10% Ratio	\$212.50	
	Quarterly reimbursement to owner/employee		\$637.50

The corporation should cut a check to owner / employee no less than every quarter for \$637.50.

This is a tax-deductible expense to the corporation and non-taxable reimbursement to the owner (owner will adjust itemized deductions on their personal tax return for mortgage interest & real estate tax reimbursed).



S-CORPORATION ESTABLISHMENT

DISCLAIMER

These materials and information should not be considered a substitute for accounting or tax advice.

While it is hoped the materials provided here are helpful as reference material, it is not warranted either expressly or implied as accurate or complete.

You should refrain in taking any action solely based upon the information provided here until you have received proper counsel. This information cannot be relied upon as support under audit by the IRS or state taxing agencies.

HOW TO GET STARTED

Getting started with your own S-Corporation is a straightforward process.

We've partnered with Arago Advocacy, an outstanding Monterey-based law practice, to provide our clients with comprehensive incorporation services.

For any questions, please contact our office at TMG@TMG.tax or call us at 831.747.1381.

- ❖ Only takes about 10 business days.
- ❖ Provide 3 available corporation name choices for registration.
- ❖ Submit a \$495 deposit towards the cost of the formation and your current contact information.

Quick Start to Establishing Your S-Corporation

1. *Think of 3 possible corporation name options.*
2. *Email us at TMG@TMG.tax with your contact information.*
3. *Pay a one-time deposit of \$495*

Process typically takes only 10 business days.