

Tax Advantages of S Corporations

TAX SECTION



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Limited liability companies can elect to be taxed under federal and state law in a number of different ways. One popular choice for small business owners is for an LLC to elect to be an S corporation.

The primary tax advantage of operating as an S corporation is minimizing self-employment taxes. When operating as a sole proprietorship (whether through a disregarded LLC or not), an individual's profits are subject to a 15.3% self-employment tax in addition to the individual income tax. The same is true for wages paid to employees of the S corporation (although in that case 7.65% is paid by the employee while the other 7.65% is paid by the S corporation itself). The IRS requires owners of an S corporation to pay themselves a reasonable salary, and not doing so (or paying too small of a salary) is the subject of many employment division audits of S corporations. However, S corporations are not required to pay out all of their profits as salaries to their employees. Rather, the IRS (in publications such as FS-2008-25) requires only that the salary be reasonable.

As an owner of an S corporation, provided you are paying yourself a reasonable salary, any profits in excess of that salary can be distributed to you. That distribution, although taxable as income, is not subject to self-employment taxes. For example, if your business made \$100,000 after expenses and operated as a sole-proprietorship, you would have to pay \$15,300 in self-employment taxes based on the tax rate of 15.3%. If, however, you instead operated as an S corporation and paid yourself a reasonable salary of \$70,000 per year, the S corporation will be responsible for paying \$5,355 in payroll taxes and the employee will pay \$5,355 in payroll taxes. The remaining \$30,000 of profit can then be distributed to the owner/employee and not be subject to any additional employment taxes. As a result, employment taxes are reduced from \$15,300 to \$10,710, for a tax savings of \$4,290. As the business grows, the tax benefits will also grow (although the owner may need to continue increasing his or her salary).

There are other advantages and disadvantages of S corporations that should be considered when deciding the tax structure of a business. These include the cost of preparing S corporation tax returns, the additional paperwork associated with corporate resolutions, and the added liability protection provided by corporations. However, the self-employment tax savings are an important factor in choosing a business tax structure.

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