

S Corp Election Self-Employment Taxes

S Corp Election



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There is a misconception floating around out there that an S Corp is a standalone entity. Not true. There are three basic business entities with variations within. The three basic are-

- Limited Liability Company (LLC), single-member or multi-member
- Limited Liability Partnership (LLP) or General Partnership (GP)
- C Corporation including Professional Corporation (some states require attorneys, accountants and doctors, for example, to be a Professional Corporation)

Two notables missing from the list. First, sole proprietors are not an entity nor is the variant "Doing Business As" (DBA). If you wake up and want to sell used copiers, you can, right now, without any formalized structure. It is not smart, but certainly permissible. At times sole proprietors are interchanged with single-member limited liability companies (SMLLC) since the IRS and most states consider a SMLLC to be a disregarded entity for taxation, and both a sole proprietorship and a SMLLC will end up on Schedule C of your Form 1040. However, they are truly different in several underlying ways.

Also note how an S corporation is not listed. It is not an entity. It is a taxation election. The underlying entity has to be one of the above, and usually it is an LLC (either single-member or multi-member) for the ease of formation yet corporations and professional corporations are common as well.

So while we might talk about your "S Corp," or "S Corp Taxes," we are truly talking about your underlying entity being treated as an S Corp for taxation. Again, this is a common misconception... no biggie if you thought otherwise. Many people do!

Avoid Self-Employment Taxes

A common complaint from those who own their own business is self-employment tax. Can you avoid, reduce, eliminate or lower your self employment taxes or SE taxes? Yes, to a large extent actually, but it takes some effort and an S Corp Election.

If you own a business as a garden variety single-member LLC (one owner or shareholder), your business income will be reported on your personal tax return under Schedule C and is subject to self-employment tax (currently 15.3%) **and** ordinary income tax. The same is true for a business that has not formed a corporation such as a sole proprietor and partnerships. So, you could easily pay an average of 40% (15.3% in SE taxes + 25% in income taxes, blended) on all your net business income in federal and state taxes. Wow!

Income taxes is largely a sunk cost. You can reduce it by having less revenue, spending more money on deductible things and / or earning some of the various business tax credits.

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If you own an LLC and have elected to be treated as an S corporation (Subchapter S) for taxation, the business now files a corporate tax return on Form 1120S. What's the big deal? Before we get into that, let's look at some quick numbers. These are based on using a salary of 40% of net business income for incomes up to \$500,000 and then decreased incrementally to 30% for the millionaire at \$2,500,000 below (real case actually)-

Income	Total SE Tax	Salary	Total PR Tax	Delta	Delta%
30,000	4,239	12,000	1,836	2,403	8.0%
50,000	7,065	20,000	3,060	4,005	8.0%
75,000	10,597	30,000	4,590	6,007	8.0%
100,000	14,130	40,000	6,120	8,010	8.0%
150,000	18,711	60,000	9,180	9,531	6.4%
200,000	20,050	80,000	12,240	7,810	3.9%
300,000	22,972	120,000	18,174	4,798	1.6%
500,000	29,991	200,000	20,494	9,497	1.9%
750,000	38,764	262,500	22,307	16,457	2.2%
1,000,000	47,537	350,000	24,844	22,693	2.3%
2,000,000	82,630	600,000	32,094	50,536	2.5%
2,500,000	100,177	750,000	36,444	63,733	2.5%

Don't get too hung up on the drop in percentages. Focus on the overall hard dollar amount. Notice the sweet spot at \$100,000 to \$150,000 (yes, it dips at \$300k due to Social Security limits). Also consider that if you run self-employed health insurance through the business (and you should), savings jumps up even more. Why? Check out our book titled Taxpayer's Comprehensive Guide to LLCs and S Corps which massively expands on this concept-Bottom line **savings is about 8-10% of your net business income** after expenses for those earning \$100,000. So, if you make \$100,000 after expenses you'll save about \$8,000 in overall taxes, and they are all self-employment taxes. Self-employment taxes = Social Security / Medicare taxes = payroll taxes. All the same thing (in general). This is 8-10% number is just a jumping off point; as the table above shows, the percentage of savings goes down as income increases but the overall savings continues to rise.

There is a cost to being an S corporation of course- all that glitters is only partially gold. See below for our S Corp "all in" packages aptly named Aspen, Vail and Breckenridge. Yup, we're from Colorado! Still not sure or not convinced? No problem... please check out Line 57 from Schedule 4 on your Form 1040 tax return. This number reflects the self-employment taxes paid on your business income. We want to reduce this by 60 to 65% and we assume you do too!

Section 199A Pass Thru Tax Reform

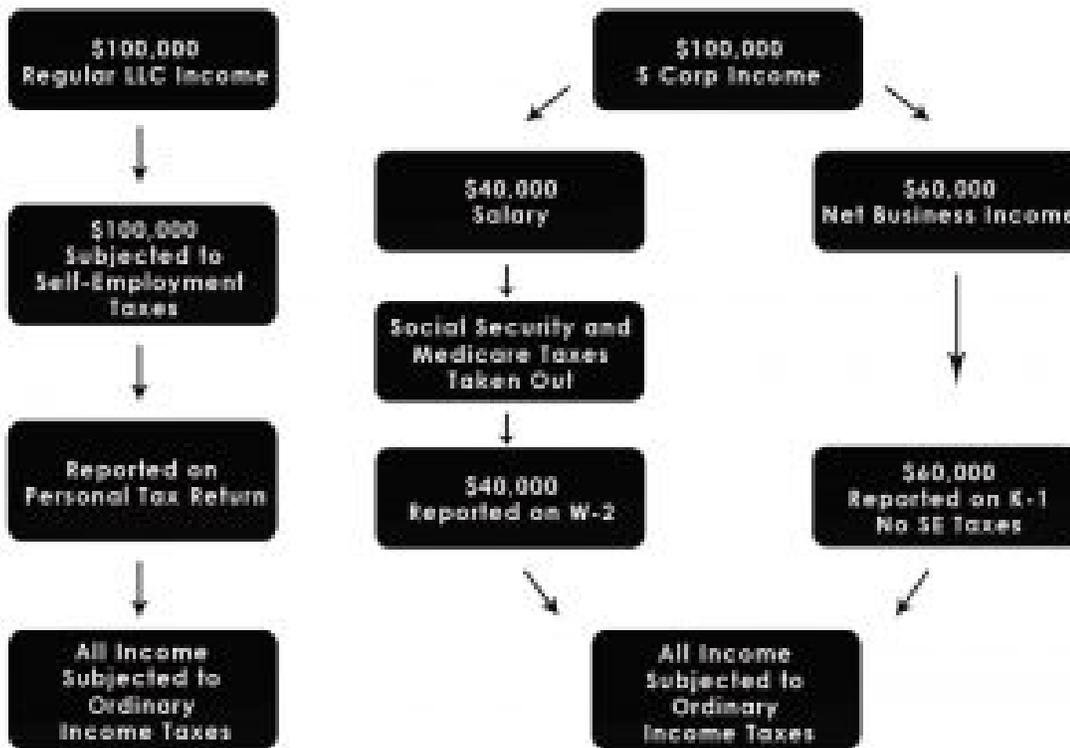
Section 199A deduction, also known as the Qualified Business Income deduction, arises from the Tax Cuts & Jobs Act of 2017. This is a significant tax break for small business owners but there are rules and limits of course. We have written several articles which outline what is considered a qualified business for the qualified business income deduction, including the dreaded specified service trade or business (SSTB) definitions (which is easily summed up as "any trade or business where the principal asset is the reputation or skill" of the owner). Click on the buttons below for our articles-**S corporations remain a critical tax saving tool for two reasons**. First, the usual self-employment tax savings remains intact for all business owners including specified service trades or businesses. Second, a business owner might need to pay W-2 wages to himself or herself to not be limited by income, and only corporations can pay W-2 wages to owners (in other words, an LLC cannot without an S Corp election). Read the articles above for riveting information including W-2 optimization and reasonable shareholder salary.

S Corp Election Money Trail

So, when your partnership, LLC or corporation is being taxed as an S Corp you are both an employee and a shareholder (think investor). As an employee, your income is subjected to all the usual taxes that you would see on a paystub- federal taxes, state

taxes, Social Security taxes, Medicare taxes, unemployment taxes and disability insurance (state specific). However, as a shareholder or investor, you are simply getting a return on your investment much like a dividend (in S Corp world this is called a distribution).

A K-1 is a statement that each shareholder receives, and it is similar to a W-2 since it reports the income that each shareholder is responsible for from a taxation perspective. There are two types of K-1s for the purposes of our discussions- one is generated from a Form 1065 and the other is generated from a Form 1120S. A Form 1065 is also called a partnership tax return, and typically your K-1 income will be subjected to self-employment taxes.



However, a K-1 generated from a Form 1120S (an underlying entity with the S Corp election) is reported on the shareholder's personal tax return on Schedule E, Page 2 just like most K-1s, but it is not subjected to self-employment taxes. Schedule E is the form used for rental properties, royalties and other investment income including business income from an S corporation.

And when we say self-employment taxes, we are really talking about Social Security and Medicare taxes. From a sole proprietor perspective, they are self-employment taxes. From an employee perspective, they are Social Security and Medicare taxes (FICA). Same thing.

Let's look at another visual in terms of how the money travels (picture time!).

So an S Corp doesn't pay taxes per se since it is a pass-thru entity, and passes its tax obligation to the investors. There are some states that charge a franchise tax such as California and Texas, and other states have an S corporation tax that is egregious such as Tennessee, New Hampshire and New York City.

Please read the full story on S corporation taxes and self employment taxes in our Taxpayer's Comprehensive Guide to LLCs and S Corps-

S Corp Election Process

How does all this work? Good question! To take an entity and have it be taxed as an S corporation by the IRS and your state, paperwork must be completed and submitted. For the IRS, [Form 2553](#) is the necessary form and it is typically due within 75 days of the fiscal year of the entity or within 75 days of inception. What if it is summer and you realized your dog ate your S Corp election paperwork? No worries! In classic IRS fashion, there is one rule and about a hundred exceptions... and Form 2553 is no different. There are provisions for a [late S corporation election](#). We can help.

Back to the issue! Form 2553 is signed in wet ink (the IRS does not accept Adobesign or DocuSign or any of those online signature apps) and then either faxed or mailed. We prefer fax. In about 10-12 weeks, you'll get an S Corp election acceptance letter. Done! If the IRS screws up the effective date, we can fix that too... remember they are humans, and can fat-finger a number like anyone else.

S Corp Election Consultation

Does an S corporation make sense for you? Can you go back in time for a late S corp election? We'll play the classic accountant and say, "it depends." But! The decision tree is fairly straightforward. Let's chat!

Name (required)

Email (required)

Business Name

Message

Phone Number (slightly required so we can stalk you)

State

Submit

Our fee is \$150 for 40 minutes (such a deal for you!). If we decide to press forward with an engagement, we will **credit the \$150 towards future services**. If you don't need convincing and already want our services such as business tax return preparation or S Corporation subscription package, and you simply have some housekeeping questions, we answer those at no charge. Charging a consult fee to tell you how great we are is not cool.

Consultations are scheduled on weekdays during the work day. Yes, we can accommodate other days and after-hours, but those are reluctantly agreed to after some eye-rolling and complaining. We will answer your questions to determine three things-

- Do you need our help?
- Can the Watson CPA Group and its **support staff** help you?
- Can we work together as a collaborative partnership?

From there we can determine the best plan which might be a simple "keep on keeping on"; otherwise we will construct a malleable plan together and provide a quote for those services.

Shockingly we actually return all consultation requests via email and phone call. No black holes here!

Late S Corp Election, Oops

Form 2553 (the S Corp election form) must be filed with the IRS. It is typically due within 75 days of forming your business entity or the fiscal year start (such as Jan 1), however, there is relief for the late filing of Form 2553 and we can guide you through that. IRS Revenue Procedures 2003-43 and 2004-48 used to be the governing rules but the IRS has simplified it (imagine that!) with **Revenue Procedure 2013-30**. We have an entire webpage dedicated to the late S Corp election. We can go back to January 2018! Check it out here-



S Corp Package

The Watson CPA Group specializes in S corporations which have a small number of shareholders, and are often just a one-person show. Did you know that 95% of all S Corps have only one shareholder, and 99% of all S Corps have three or fewer shareholders? Because small business is a core competency for us, we have created an S corp package that includes the following (No, the S doesn't stand for stormtrooper)-

	A la Carte*	Aspen	Vail	Breck
S Corp Reasonable Salary Calculation (sample report)	\$400	Yes	Yes	Yes
Section 199A QBID Tax Optimization (more info)	\$300	Yes	Yes	Yes
S Corp Payroll Filings and Deposits	\$1,200	Yes	Yes	
Annual Processing (W2s and other filings)	inc.	Yes	Yes	
S Corporation Tax Prep (Form 1120S)	\$800 to \$1,200	Yes	Yes	Yes
Individual Tax Prep (Form 1040), One Owner	\$500 to \$700	Yes		Yes
Estimated Tax Payments (done thru payroll or directly by us)	\$300	Yes	Yes	Yes
2019 Tax Planning, Mock Tax Returns (Tax Questionnaire)	\$300 to \$500	Yes	Yes	Yes
Unlimited Consultation and Periodic Business Reviews (PBR)	\$1,200	Yes	Yes	Yes
First Research Industry Reports (sample report)	\$150	Yes	Yes	Yes
Small Business Tax Deductions Optimization	inc.	Yes	Yes	Yes
IRS Audit Defense	NA	Yes		Yes
	Annual Fee	\$2,940	\$2,700	\$2,640
	Monthly Fee	\$245	\$225	\$220

Note: A la Carte fee ranges are approximates. 90% of our clients fit into these fee ranges, but there are outliers. We have a handful of clients with over 30 rentals; their individual tax return is north of \$2,500. We also are assuming one state; if your business spans the galaxy (keeping with our stormtrooper motif) then additional fees will be discussed with you and implemented. Typically each state is around \$250 since it affects both your business and individual tax returns (frankly, state apportionment is a pain in the butt, but it is our pain).

Couple of other things to keep in mind- we make very little profits on payroll processing... we offer it as a convenience to our clients. One throat to choke with a single call can be reassuring but if you want to run your payroll, go for it! Everyone thinks payroll is a piece of cake; write a check and done. Nope... we see a lot of mistakes being made by clients especially the handling of health insurance and HSA contributions since there are special rules.

You can prepare your own individual tax return (Vail package) as well... but the benefit of the Watson CPA Group preparing both tax returns is that we slide things around depending on income limitations, phaseouts, alternative minimum tax (AMT), Section 199A deduction optimization, etc. Having our arms around both can yield some good tax savings!

Some more things to consider- when a partial year remains, our usual annual fee is pro-rated to not charge you for services you didn't use (like payroll and consultation). However, a large chunk of our annual fee is tax preparation which is typically a fixed amount of \$1,300 (both corporate and personal). Whether we onboard you in January, July or December, we have to prepare a

full year tax return. This increases the monthly fee for the remaining months of 2019 but the monthly fee will later decrease in January of 2020 to reflect the amounts above. Yeah, we make it sound like 2020 is just around the corner.



No BS

We are not salespeople. We are not putting lipstick on a pig, and trying to convince you to love it, even if Tom Ford's Wild Ginger looks amazing. Our job remains being professionally detached, giving you information and letting you decide.

We see far too many crazy schemes and half-baked ideas from attorneys and wealth managers. In some cases, they are good ideas. In most cases, all the entities, layering and mixed ownership is only the **illusion of precision**. Just because you can complicate the crap out of your life doesn't mean you must.

Section 199A Deduction Optimization

Section 199A is a derivative of the recent Tax Cuts & Jobs Act of 2017. In a nutshell, business owners including rental property owners will enjoy a 20% deduction based on the qualified business income. There are limitations based on income, W-2 wages and depreciation. As a result, there is some optimization that is necessary for a small business owner to get the most from the Section 199A deduction. On one hand we want to reduce W-2 salaries to shareholders to minimize self-employment taxes. On the other hand, we want to increase W-2 salaries so they do not limit the amount of Section 199A that is deducted. Read our full Section 199A Qualified Business Income article by clicking on the button below-

[Pass Thru Tax Reform](#)

Our Business Expertise

S Corp Election Checklist

So we showed you all the benefits, fees and such... but we need to put the horse back in front of the carriage. Let's go through a quick checklist to ensure that we are not going down the wrong road. As Doc Brown in Back to the Future says, "Roads? Where we're going, we don't need roads." Well, in S Corp land we do-

1. Does your business earn over \$30,000 net income after expenses? **Say Yes.**
2. Are you located in New York City or Tennessee where S corporation tax rates are egregious and suck up all the federal tax savings? New Hampshire? **Say No.** Although there might be exceptions where an S Corp makes sense NYC, TN and NH in order to maximize Section 199A deduction benefits.
3. Do you have other W-2 income that exceeds or comes close to exceeding the Social Security limits of \$132,900 (2019)? **Say No.** If you say Yes, we need net business income to exceed \$200,000 in #1 above so that the Medicare savings exceeds the "lost" Social Security tax paid by the S Corp.
4. Is this a going concern? In other words, is the business going to continue to earn the same income or more each year? **Say Yes.**
5. Do you have an LLC or some other entity in place that can be elected to be taxed as an S Corp? **Say Yes.** If you say No, we have options just not elegant ones such as shelf corporations.
6. Do you have other partners besides a spouse... business partners, that is? **Say No.** If you say Yes, are you currently splitting income based on ownership percentages or some formula? If you say Formula, then we'll need to explore a [multi-entity arrangement](#).
7. Does your entity own any appreciating assets such as real estate? **Say No.** We don't put appreciating assets into an S corporation. Holding companies own real estate and operating companies elect S Corp status. Chinese Wall.

Are you still here? Excellent news... read on! You can also complete a PDF version of the above questions, and send them to us for review-Common S Corp candidates and current clients for the Watson CPA Group are consultants, engineers, financial advisors, physicians, chiropractors, doctors, surgeons, anesthesiologists, nurse anesthetists, insurance agents, attorneys, photographers (the profitable ones), online retailers, FBA retailers, real estate agents, good old fashioned widget makers, among several others. We also have several medical groups and financial advisor teams. Yes, even those deemed to be specified service trades or businesses still benefit with Section 199A coupled with an S Corp election!

Self Employed 401k Plan

Now that you can save thousands of dollars in self employment taxes with an S Corp election, you should invest that wisely. The Watson CPA Group is a small business too, and we understand that any extra dollars usually get invested back into the growing company. Having said that, there are several small business retirement plans which include solo 401k plans, profit sharing plans, cash balance and defined benefits pensions.

For example, with a solo 401k plan piggybacked with a defined benefits pension, you could sock away over \$192,000 at age 50. All tax deferred if you like, which could yield a **tax deferral savings of over \$86,000** (assuming a 45% marginal tax rate with federal and state). Wow!

Note how we purposely did not mention SEP IRAs. These are old school and are usually designed to be crisis management tools (after the fact) rather than good planning tools. Read more about the various self employed retirement options, including retirement tax bombs and the difference between tax deferral and tax savings below-Please contact us today to review your particular situation and see if electing S Corp status makes dollars and sense! All the cool kids are doing it- well, most, and we'll have to ask several questions to make sure the fit is right.