

Using an S Corporation to Reduce Your Income Tax

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If you're an entrepreneur or small-business owner, you may be aware of a common tactic for reducing your income tax: You form an S corporation and then use it to pay yourself a combination of wages and distributions. Put simply, an S corporation is a corporation that chooses to be taxed as a pass-through entity (*a business structure where the profits and losses "pass through" directly to the owners, who report them on their personal tax returns, instead of the business paying corporate taxes*). Under this plan, you pay income tax on both wages and distributions, but you pay self-employment tax – Social Security and Medicare – only on wages. Income from distributions is not subject to Social Security and Medicare withholding.



On its surface, this tactic saves you about 15.3 percent in taxes on the amount you pay yourself in distributions, because as an employer/employee, you're responsible for paying both halves of Social Security and Medicare. As an employer, you pay 6.2 percent Social Security and 1.45 percent Medicare, and an amount equivalent to that as employee. If you crunch the numbers, that's 6.2 percent + 1.45 percent = 7.65 percent x 2 = 15.3 percent.

However, you need to be aware of three important considerations:

1. First, you don't save 15.3 percent in income tax; you save 15.3 percent only on the amount you pay yourself in distributions, and that's usually half or less of the total you receive from your business. We will spare you the calculations, but suppose you have a business with a net profit of \$100,000, and you file as a single taxpayer. If you report the entire profit as wage income, you'd have to pay about \$13,617 or 13.61 percent in self-employment tax (after

accounting for the fact that you can deduct half of what you pay in self-employment tax from your reported income). If, instead, you were to pay yourself \$50,000 in wages and \$50,000 in distributions, you would pay about half that – \$6,808.50 – in self-employment tax. That's still a significant amount of money, but it's not \$15,300.

2. Second, when you use this tactic to reduce your self-employment tax, you're also reducing your reported income, which will negatively impact your Social Security income when you're ready to retire. Your Social Security income is calculated based on your highest 35 years of earnings adjusted for wage inflation. That may not make a huge difference, but it will lower the monthly amounts you receive when you decide to claim your Social Security retirement benefits.
3. Third, the tax code requires that you pay yourself "reasonable compensation" in the form of W-2 wages before taking any distributions. If you're not paid *reasonable* compensation, the IRS may recharacterize a portion of your distributions as wages, which are subject to Social Security and Medicare withholding, and you may be subject to penalties and interest.

This third consideration is what we focus on in this SWC singlette about an S Corporation to reduce your income tax.

Common S Corp Practices That Can Get You into Trouble

The IRS is well aware of the tactic of using an S corporation to reduce the self-employment tax, so avoid the temptation to use an arbitrary percentage or amount to determine "reasonable compensation." According to IRS guidelines, compensation (the wages portion) should reflect the fair market value of the work performed.

One common practice that can attract IRS scrutiny is to use a 50/50 split – you pay yourself half your business's net income in the form of wages and take the other half in the form of distributions.

Another common practice that can get you into trouble is to set compensation at the annual maximum taxable earnings for Social Security, which is \$168,600 for 2024. An arbitrary number like that will raise a red flag.

Deciding What Qualifies as "Reasonable Compensation"

To avoid potential issues, consider using one of the following methods to determine what constitutes "reasonable compensation":

- **The cost, or the "many hats" approach** is suited for small businesses in which owners take on multiple roles. It breaks your duties down into distinct roles, such as administration and marketing. You determine the wage for each role based on your research of salary surveys, then calculate your total wage based on the amount of time devoted to each role.
- **The market approach** sets your compensation in line with the compensation paid for similar positions in the industry.
- **The income approach**, or "independent-investors test" may be helpful when there isn't enough data for comparison or when the situation is unusual. It looks at whether a potential investor in an S corporation would consider the return on their investment to be reasonable based on the owner's salary and the fair market value of the business.

Whatever method you follow, be sure to document both the criteria and reasoning you followed to estimate your compensation, so that if you are audited, you have proof that the salary/distribution split you arrived at is reasonable. Here are some key factors for determining “reasonable compensation” that should be included in your documentation:

- Duties performed by the employee
- Volume and complexity of business handled
- The employee’s level of responsibility, time commitment, and individual achievements
- The business’s overall compensation policies
- Historical salary data of the shareholder and comparable wages in similar businesses
- The intent of the payments to employees

Complying with that last item in the list (intent) can be tricky. That’s because deductible compensation must correspond directly to the services your business provides. To substantiate *compensatory intent*, we recommend that our clients keep meticulous documentation, including uncompromising records of duties and hours worked, minutes from board meetings, payment of employment taxes (for Medicare and Social Security withholding), Forms W-2s, and payroll tax return documentation. Lack of intent for compensation may lead to reclassification of certain transactions, such as catch-up payments, including dividends, distributions, or additional wages.

Protecting Yourself Against IRS Audits and Auditors

Here at SWC, we don’t believe in making taxpayers afraid of the Internal Revenue Service (IRS). Fear can lead individuals and organizations to pay more in taxes than they are obligated to do so. That said, we take an aggressively thoughtful approach to tax-saving that’s backed up with impeccable documentation. In that way, our clients are well prepared to justify what they paid in taxes.

However, you should be aware that the IRS is intensifying its enforcement efforts and targeting complex passthrough entities, such as S corporations, in particular. Using artificial intelligence and advanced technology, the IRS is ramping up its detection capabilities for tax-compliance issues and emerging threats in order to prioritize its investigations. Audits of related areas may alert the IRS to reasonable-compensation issues. These “related areas” include the following:

- Payroll taxes
- W-2 forms issued by S corporations to their owners
- Employee retention credit claims (businesses that claim a tax credit for retaining employees during the COVID-19 pandemic)
- Form 941, *Employer’s Quarterly Federal Tax Return*, which the IRS may audit to assess whether independent contractors should be classified as employees
- The qualified business income (QBI) deduction, which may also draw IRS scrutiny in the context of determining reasonable compensation

In other words, even if an IRS investigation does not target reasonable compensation directly, it could uncover issues that lead it in that direction later.

Ensuring IRS Compliance

Regardless of whether your small business has been compliant in the past, we can help you achieve and maintain compliance in several ways, including the following:

- Analyze your business and personal finances and advise you on the most financially savvy approach to getting money out of your business. We can crunch the numbers to examine not only the short-term benefits but also how this tax-saving strategy will affect your future social security benefits.
- Perform an annual compensation analysis for each S corporation for which you are a shareholder-employee.
- Determine a reasonable split between compensation and distributions.
- Review your past records and help bring you and your business into compliance, if it isn't in compliance.
- Ensure that you are keeping accurate records, filing the required paperwork, and making required tax payments on a timely basis.
- Serve as your representative in the event that you or your business is selected for an IRS audit.

Our focus is on minimizing your taxes and maximizing your wealth, while protecting you from tax audits and penalties. Please contact us to schedule a consultation.

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