Title:
How to Save Thousands with an S Corporation

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Summary:
Ever wondered why more than three million business owners and entrepreneurs operate their firms as S corporations? Because they save thousands annually in taxes. Want to know how to get your fair share of these tax savings? Read tax professor and CPA Stephen L. Nelson's down-to-earth explanation of how an S corporation saves business owners money.

Keywords:
s corp, llc, s election, subchapter s, s corporation

Article Body:
How to Save Taxes with an S Corporation

Ever wondered why so many small businesses—more than 3,000,000 at last count—operate as an S corporation? Simple. An S corporation saves business owners big taxes in three separate ways:

First, as compared to regular corporations (sometimes called C corporations), S corporation owners can use the business’s losses incurred during the early lean years on the owner’s personal returns as deductions. For example, suppose a new S corporation suffers a $20,000 loss its first year and that the corporation is equally owned by two shareholder-employees, Smith and Jones. Smith and Jones each get a $10,000 business deduction on their individual tax returns because of the S corporation loss. This $10,000 deduction might save them each as much as $4,000 in federal and state income taxes.

A second, big S corporation benefit: As compared to almost every other business form, S corporations can save their owners self-employment or Social Security/Medicare taxes. Suppose, for example, that Adams, Brown and Cole independently each own businesses that make $90,000 a year in profits. Each business owner may pay $13,000 in income taxes. But, unfortunately, that’s not the only tax they pay. Each owner also pays self-employment or Social Security/Medicare taxes.

For example, Adams operates his business as an LLC and therefore pays 15.3%, or roughly $13,500, in self-employment taxes on his profits.

Brown operates his business as a C corporation which pays all of its profits to him as a salary. Accordingly, Brown (through his corporation) also pays 15.3%, or roughly $13,500, in Social Security and Medicare taxes.

Cole’s situation is different. Cole operates his business as an S corporation which means that Cole can split his $90,000 of profits into two payment amounts: salary and S corporation distributions. Suppose that Cole says only $40,000 of his profits are salary and takes the other $50,000 as a “dividend” distrbution. In this case, Cole pays the 15.3% Social Security/Medicare tax only on the $40,000 in salary. Cole therefore pays roughly $6,000 in Social Security/Medicare taxes—and annually saves $7,000 in taxes as compared to Adams or Brown.

S corporations also, sometimes, provide a third form of tax savings because S corporations don’t pay corporate income taxes. This means that S corporations avoid the often-talked about “double-taxation” problem. However, the “no corporate income taxes” benefit often isn’t a savings for small corporations and their owners.

But let me explain. Suppose that two corporations each earn the same pretax profit of $100,000 and are owned by Ms. DaVinci who pays the highest federal income tax rate of 35%. One corporation is an S corporation and the other is a C corporation. The S corporation can distribute the entire $100,000 in profits to DaVinci as dividends because there is no corporate income tax. DaVinci then pays $35,000 in personal income taxes on the S corporation profits, which means she nets $65,000 in after-tax profits from the S corporation. In comparison, the C corporation can’t pay the entire $100,000 in profits to DaVinci. The C corporation first pays $22,250 in corporate income taxes. When the C corporation pays the remaining $77,750 to DaVinci as a dividend, DaVinci pays another $11,663 in 15% “dividend” taxes on the C corporation profits. This means that DaVinci nets roughly $66,000 in after-tax profits from the C corporation profits. In this case, DaVinci saves money with a C corporation in spite of having to pay the corporate income tax.

How to Get S Corporation Benefits

To create an S corporation and receive S corporation tax savings, you need to do two things: First, you must incorporate the business either as a regular corporation or as a limited liability company. Second, you need to make an election with the IRS to have the corporation or LLC treated as an S corporation. The S election is made with form 2553, available from the www.irs.gov web site. Note that some states (such as New York) require a separate state S election.

A final tip: S corporations can save you thousands of dollars annually, but your tax savings can’t start until you elect S corporation status. If you’re interested is electing S status to save on taxes for next year, you may want to call your tax advisor or attorney right now!