

How Creating an S Corporation Can Reduce Your Self-Employment Taxes

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Creating an S Corporation can potentially reduce self-employment taxes by allowing business owners to split their income into salary and distributions. While salary is subject to employment taxes, distributions (such as payments that are made to shareholders

from a portion of company profits) can potentially be exempt from those taxes. Here's what you need to know.

If you are an entrepreneur, a [financial advisor](#) can work with you to create a financial plan for your needs and goals.

How Self-Employment Taxes Work

To understand [self-employment taxes](#), let's break them down to their fundamentals: they consist of 12.4% for [Social Security](#) and 2.9% for [Medicare](#), culminating in a total tax of 15.3%. This tax can add up over time as you're paying that every year, in some cases on top of [paying](#)

[business taxes](#) in some states.

Now, imagine you run a freelance graphic design business earning \$50,000 in net income, all of it may count as your individual earnings, depending on your business formation of choice. You would pay \$7,650 in self-employment taxes (15.3% of \$50,000), significantly impacting your net income. It's important to understand how you plan on setting your business up and what your long-term goals are, such as whether you plan on having employees, so you can make the right long-term tax decisions.

How S Corporation Taxes Work

S Corporations stand out with their distinctive tax structure, which can be a huge benefit to some. They function as pass-through entities, bypassing corporate federal income tax with corporate income, losses, deductions and credits passing through to shareholders. These 'pass-through' components effectively integrate into their personal tax returns, effectively sidestepping the potential double taxation that C Corporations face.

This feature makes S Corporations attractive to many self-employed individuals. S corporations are its own formation option but you could also be taxed as an S corporation if you open a [limited liability company \(LLC\)](#) as well. Decisions between [S and C Corporations](#) (or how to be taxed as an LLC) can be complex, so consulting a financial advisor who can tailor advice for your situation can be incredibly beneficial.

How S-Corp Distributions Are Taxed



When we talk about distributions, we are referring to shareholders getting their share of the profits from an S Corporation. These distributions are taxed individually, and they are not subject to self-employment taxes, leading to

potentially significant tax savings. However, there's a catch: shareholders must receive a "reasonable compensation" which basically means you must pay yourself a reasonable salary if you work at the company. Your salary is taxed normally in your [tax bracket](#).

Let's consider a business owner who earns a substantial income of \$100,000. Her reasonable compensation might be \$80,000, leaving \$20,000 as a distribution that isn't subject to employment taxes (though it would still be subject to regular income taxes). While this strategy could help lower your overall tax liability, you should note that it does not guarantee any tax savings, as it will depend on your specific finances.

Reasons You May Want to Use an S Corporation

While tax savings can be a significant benefit, it is crucial to consider other factors specific to your business and long-term goals before [choosing an S Corporation](#). Factors like the ability to attract investors through stock issuance, the nature of your business and your earning potential play an equally important role. Consulting with a financial advisor can help in this decision-making process, evaluating upsides and risks with an S Corporation choice.

Risks of Using an S Corp

Choosing an S Corporation doesn't necessarily translate into smooth sailing as it is very dependent on your situation.

First, you should note that the potential tax savings may not always offset the administrative costs of maintaining an S Corporation, especially for smaller businesses with limited profits.

Second, even though the S corporation itself doesn't pay any income taxes, it still has to file a tax return, which can cost several thousand dollars to prepare.

Third, many experts will tell you that there is a certain income you should meet before [electing an S Corporation](#), in most circumstances, so that the benefits more than offset the costs.

And fourth, bear in mind that this business structure requires that you pay reasonable salaries (which are subject to employment taxes), and restricts the number of shareholders to 100 U.S.

citizens or residents.

Bottom Line



While S Corporations could help you minimize self-employment taxes by splitting income into salary and distributions, you should be aware of the requirements and potential risks before setting up this business structure.

Tips for Tax Planning

- A [financial advisor](#) who specializes in tax planning can help you protect your finances and avoid any unnecessary taxes while helping you maximize how much wealth you keep. Finding a financial advisor doesn't have to be hard. [SmartAsset's free tool](#) matches you with up to three vetted financial advisors who serve your area, and you can have a free introductory call with your advisor matches to decide which one you feel is right for you. If you're ready to find an advisor who can help you achieve your financial goals, [get started now](#).
- If your tax situation is less complicated, you may just want to estimate what you might be on the hook to pay so you can plan accordingly. If that's the case, consider using SmartAsset's free [income tax calculator](#).

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