Saving Business Taxes with an S Corporation

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S Corporations, produce several tax benefits as compared to Sole Proprietorships, Partnerships, LLC's, and C Corporations.

The big benefit -- and the one that people usually talk about -- is the payroll tax savings. To understand how this works, let me compare two alternatives: A Sole Proprietor making $90,000 a year and an S Corporation making $90,000 a year.

Of course, the taxes that a Sole Proprietor pays depends on his or her filing status, itemized deductions or standard deduction, and family size - but typically such a person might pay about $12,000 in federal income taxes. The person might also pay another chunk in state income taxes (varies by state).

In addition to these income taxes, the Sole Proprietor also pays a 15.3% self-employment tax on the $90,000 of business profits. Roughly, this self-employment tax (which is equivalent to Social Security and Medicare tax) equals $13,000.

Things usually work differently for the S corporation, however. To make calculations easy, assume the S Corporation is owned by a single shareholder. In this case, the S Corporation must break the $90,000 of profit into two buckets: wages and the leftover (which is called a distributive share). If the wages equal $40,000 and the leftover distributive share equals $50,000, the business pays Social Security and Medicare taxes (equivalent to self-employment tax) equal to roughly $6,000 (only on the wages portion).

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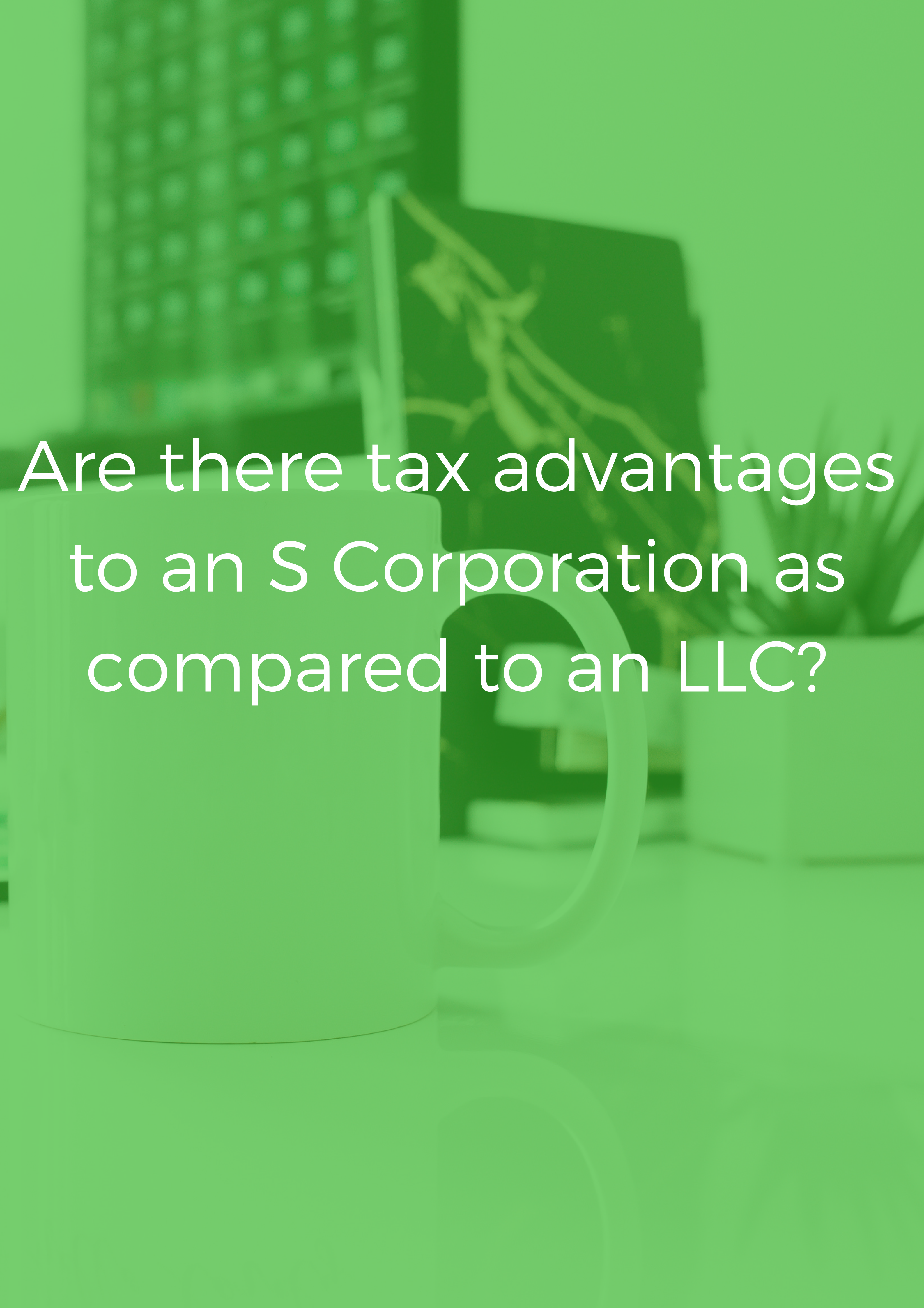
In this case, even though the two businesses make the exact same amount of money, the S Corporation pays roughly $7,000 less in tax each year.

In addition to the big benefit of self-employment tax reduction, S Corporations also provide two other useful benefits -- benefits which are a little more difficult to quantify but still important nonetheless.

One such benefit is that S Corporation losses (such as those that often occur in the early startup years) can be used as tax deductions on those shareholders personal income tax returns.

Another such benefit is that the S Corporation isn't taxed on the S Corporation profits -- at least by the federal government.


Are there tax advantages to an S Corporation as compared to an LLC?

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Are there tax advantages to an S Corporation as compared to an LLC?

An S Corporation may have several potential advantages as compared to an LLC, or Limited Liability Company.

Before I discuss the relative tax advantages of an S Corporation versus LLCs, however, I should go over the basics of S Corporation and LLC taxation.

BASIS OF S CORPORATION VERSUS LLC TAXATION

S Corporations are created when an eligible entity (traditionally a corporation) elects to be treated according to the rules of Subchapter S of the Internal Revenue Code and its related regulations. S Corporations, therefore, are really a tax accounting classification rather than a legal entity.

An LLC, in contrast, is actually a legal entity created by state law through the filing of articles of LLC formation or some similar document.

A second important point: an LLC is a chameleon for tax purposes. LLC's with one owner or "member" can be disregarded (or ignored) for tax purposes. And this "ignoring" or "disregarding" just means that the LLC's activities are reported on its owner's regular income tax return.

The one member LLC can also elect to be treated as a regular corporation, called a "C Corporation," or it can elect to be treated as an "S Corporation."

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Are there tax advantages to an S Corporation as compared to an LLC?

An LLC with multiple owners, or "members,' can be treated as a partnership for tax purposes. The multi-member LLC also can elect to be treated as a regular corporation or, again, as an S corporation.

To sum up, the legal entity called an LLC can elect to use the S Corporation tax accounting classification. (Many people, even professionals who should understand this, unfortunately, don't.)

Once you understand these two points, you can more easily understand the tax advantages of S Corporation versus LLC status.

Tax advantages of S Corporation versus LLC

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Tax advantages of S Corporation versus LLC

A single-member LLC treated as a disregarded entity reports its income and deductions on a Schedule C tax form if the LLC operates an active trade or business. This tax accounting means that the LLC owner pays self-employment taxes (roughly 15% on the first $100,000 of profits and then 3% on profits after that).

Note: a multi-member LLC is treated as a partnership for tax purposes, in this case, the individual partners are also liable for self-employment tax.

In comparison, a single member LLC operating an active trade or business and treated as an S Corporation has to file a corporate tax return and regular payroll tax returns. However, the S Corporation status means that the business pays Social Security and Medicare taxes equivalent to self-employment taxes (again roughly 15% on the first $100,000 of profits and then 3% on profits after that) only on the amount of profit called "wages."

To show you how powerful this self-employment tax savings gambit can be, suppose that an LLC makes $100,000 in profits. If the LLC is treated as a sole proprietorship, the self-employment tax bill roughly costs $15,000 each year.

If the LLC is treated as an S Corporation and the owner, wage amount is set to $50,000, the self-employment tax bill roughly costs $7,500 each year.

S Corporation status in this example saves the owner roughly $7,500 annually in employment taxes.