Season 1 – Episode 6 - Balancing Act: S-Corporations, Self-Employment Taxes and Your Retirement

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Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, personal financial specialist and enrolled agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today we're going to delve into a topic that's often misunderstood but can have significant tax implications for small businesses and self-employed professionals. Scorpions and Self Employment Taxes Scorpions can be an excellent tool for saving on self-employment or se taxes, especially when compared to other forms of businesses like sole proprietorships and partnerships. Let's start by understanding how the tax structure works in these cases. A sole proprietorship or a partnership where you materially participate is subject to SC tax on all of their earnings, while only the owner wages in an S corporation are subject to SC tax. Let's use an example for clarity. Imagine a consulting business that makes 150,000 in net income for the year. If you are a sole proprietor or in a general partnership, the entire $150,000 is subject to self-employment taxes, which are currently 15.3%. However, if you operate the same business as an S corporation and pay yourself a wage of 75,000, then only that 75,000 is subject to the 15.3% self-employment tax.

The remaining 75,000 would be taxable as ordinary income, and it will not be subject to self-employment tax, saving you a significant amount of money. You may be thinking, why pay anything in a wage if I can save 15.3% on anything not paid as a wage? The problem is, the IRS knows this quote unquote loophole and requires you to pay the owner employee a reasonable wage. Well, since that is required by the IRS, what is a reasonable wage? It isn't defined in the code or regulations, so the courts have been left to defining what that is. And like most things in tax, it depends on the business and various factors like profitability, the industry, and cash flow, among many other things. A general idea, though, is that a reasonable wage is defined as what you would pay for a similar job in the open market.

Failing to pay a reasonable wage might prompt an IRS audit, and if the IRS wins the argument and you are determined to have underpaid a wage, you will be subject to back, payroll taxes, interest and penalties. Therefore, it's vital to set a reasonable wage reflecting the value of the services you're providing to your company, considering factors such as time, effort, skill level, and the going rates for similar services. But just like most things in life, there's a flip side to this. While underpaying yourself might save you some SC tax now, it could cost you more later. Specifically, when it comes to your retirement. And here's how your Social Security benefit in retirement is calculated based on your 35 highest earning years, underpaying yourself now means you're potentially reducing your Social Security income in the future. It might seem like a good idea in the short term, but it could lead to a reduced income during your retirement years, which might not be the best financial decision in the long run.

Let's dive a bit deeper into how Social Security earnings are calculated to see where an optimal amount of earnings can be utilized. The Social Security Administration, or SSA, adjusts or indexes your actual income to account for changes in average wages since the year the income was received. They do this to ensure your earnings are reflective of the general wage levels at the time you apply for Social Security. Then they take each year's earnings up to the maximum taxable earnings for that year and add them together. This total is then divided by the number of months in 35 years to get your average indexed monthly earnings, or AIME. Now, how the SSA translates the AIME into your actual benefits involves a formula known as bend points. Bend points are income thresholds set each year by the SSA. The benefits formula is progressive, meaning it favors low-income earners.

The bend points of $996 and $6,002 in your AIME translate to portions of your average earnings that are considered in determining your Social Security benefits. The monthly bend points of 996 and 6002 translate to annual figures of 11,952 and 72,024 respectively. Here's how the calculation works the SSA takes into account 90% of the first $11,952 of your average indexed annual earnings. If your earnings are at least 11,000 952, this translates into a benefit credit of $10,756, which is 90% of the 11,952 for the portion of your earnings that fall between 11,000 952 and 72,024, the SSA takes into account 32%. If your annual earnings were 72,024, this part would contribute $19,223 to your benefits, which is 32% of the difference between 72,000 and 11,952. Lastly, for any party earnings that exceed the 72,024, the SSA takes into account 15%. So if you had earnings of 82,024, this would contribute an additional one $500, which is 15% of the difference between the 82 and the 72 to your benefits.

It's important to remember these numbers can change each year due to inflation and other adjustments made by the SSA. So always check the current figures. So when applying this to your wage as an S Corp. Owner, paying in the second tier up to around 72,000, assuming this is a reasonable wage for your business will generate a 32% Social Security benefit where you are paying in at 15.3%. It's a pretty solid return going into the third tier, a wage over 72,000 will generate only a 15% Social Security benefit. As mentioned, you're paying in at 15.3, so receiving a 15% benefit on 15.3% in taxes owed not really a good return. So, keeping your owner wage below the third tier, if possible, due to the reasonable wage requirement, will be a prudent way to structure the amount of the owner wage. So, before you decide to slash your salary, think about the potential long term implications.

It's about balancing your immediate tax savings with the future retirement benefits. Tax planning is not a one size fits all approach. It requires careful consideration of your individual circumstances, both now and in the future. Remember, tax laws are complex, and this podcast is not intended to replace professional advice for your specific situation. Always consult with a tax professional before making any major decisions about your business structure or tax strategy.

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