

# To Legally Save Thousands of Dollars a Year in Taxes

By Roberto Neuberger

To Legally Save Thousands of Dollars a Year in Taxes

Roberto Neuberger  
support@activefilings.com

Active Filings <http://www.activefilings.com>

How To Legally Save Thousands of Dollars a Year in Taxes

By Alex Goumakos

Someone once remarked, "Next to being shot at and missed, nothing is quite so satisfying as an income tax refund." There's no question that saving money in taxes is high on everybody's list of financial priorities, especially self-employed business owners.

However, unlike individuals who work as employees for an employer, business owners actually have the "luxury" of choosing how much in taxes they pay each year by picking one form of business entity (sole proprietorship, partnership, corporation, etc.) over another.

Unfortunately, the majority of business owners choose a business entity once (usually when starting out) then keep the same entity for the life of the business. This isn't necessarily the smart thing to do.

While some companies can get away with sticking with the same form of business throughout the life of the business, countless others are just simply throwing money out the window by overpaying their taxes. For some small business owners, this "financial nonchalance" can actually cost an extra several thousand dollars in unnecessary and avoidable taxes each year.

If you are a business owner concerned about reducing your tax liability, here's a way you can dodge the tax bullet by utilizing what's known as a Subchapter S corporation:

First some background: When starting a new business most business owners focus on simplicity: that is, the less paperwork and regulations to contend with the better.

What this means is that most new businesses start out as "unincorporated" entities such as sole proprietorships (73%) and partnerships (6%). While management and administrative costs of running the business might be easier and less expensive initially, the tax burden, especially the self-employment tax, can be anything but.

For many business owners who wait till year-end to do their tax planning (or no tax planning at all), the self-employment tax is an unwelcome surprise...and a very large expense. Newly self-employed

individuals are shocked even more once they realize that they are responsible for the self-employment tax all on their own. That's because when they worked as an employee their employer was responsible for paying one half of the self-employment tax.

The self-employment tax is simply a version of the same Social Security and Medicare taxes you pay as an employee. However, instead of paying 7.65% as you do when you're an employee, as a self-employed business owner you have to pay double: 15.3%.

In 2002, the Social Security portion (12.4%) is levied on the first \$84,900 of net profits. There is no limit to the Medicare portion (2.9%). Self-employed individuals are also entitled to a one half-credit of the tax. As an example, a self-employed individual with \$100,000 in net profits in 2002 would be required to pay \$12,400 in self-employment tax. This tax is in addition to federal, state and local taxes!

Here's what you can do to save money on the self-employment tax

Incorporate and elect Subchapter S status. You can elect Subchapter S status even if you have a pre-existing C corporation too. Operating your business as an S corporation is one of the very few four leaf clovers still left in the tax code.

The reason for this is simple: The net income from an S corporation is NOT subject to the self-employment tax.

If structured and implemented properly, an S corporation could save you thousands of tax dollars per year. As an employee-shareholder of your S corporation, you pay yourself wages just like you would any other employee. But instead of taking profits out through payroll, you take cash distributions called "nontaxable dividends".

Nontaxable dividends are called nontaxable, because they aren't double taxed like the dividends paid to shareholders in a regular C corporation. You're still paying taxes on the net income of your S corporation when you file your personal tax return, but the tax is federal tax and not the self-employment tax.

For the sake of simplicity, if an S corporation with \$100,000 of net profits pays its owner a reasonable salary of say \$50,000 and non-taxable dividends of \$25,000, the tax would be \$7,650. This is a whopping \$4,750 savings in tax! Even if you factor in additional costs such as workman's comp insurance, incorporation costs, professional fees and incidentals, the savings is still more than adequate.

The key to the whole scenario is that your salary must be reasonable under the circumstances surrounding your business. It's also much better for salary justification purposes if your business is not limited to the delivery of personal services by you. Nevertheless, incorporating and electing Subchapter S status is an excellent way to reduce your overall tax burden.

Here's more good news: If you happen to already own a regular C corporation and you live in a state that has a high corporate income tax rate, you'll come out ahead even more if you elect S status. Additionally, if you have children aged 14 or older, you can save even more taxes by giving them shares in your S corporation and having them pay the tax at their lower tax rates. By giving away shares you also reduce your estate tax obligation.

So you see, there are plenty of good reasons to incorporate and elect S status. I've only touched

on a few minor points. There are many, many other valid reasons to incorporate. Just keep in mind that you should always consult with your tax advisor for your particular needs and circumstances before making any important business or financial decisions. Besides taxes, there are many legal and financial issues to contend with as well. Always look before you leap.

When it comes to your business, you should make it a point to assess the validity of your type of business structure on a yearly basis. Incorporating is definitely not just for startups. There are plenty of unincorporated businesses that are missing the boat when it comes to saving money. Don't be one of them. It pays to find out more.

Alex Goumakos is a CPA, business advisor and guest consultant of Active Filings LLC, a company that provides incorporation services in all US. (<http://www.activefilings.com>). Alex can be reached by email at <mailto:alex@activefilings.com>

[Get-Articles.com : 1000's of reprintable business and internet marketing-related articles.](#)

[Submit your article for reprint.](#)