For 2017, The White Coat Investor, LLC is going to be filing taxes as an S Corp for the first time. We’re not technically incorporating, since the LLC structure works well for us, provides similar liability protection, and is low cost. But the IRS allows an LLC to choose to be taxed as a sole proprietor (if one owner), a partnership (if more than one owner), or a corporation (any number of owners.) If you choose to be taxed as a corporation, you can do an “S Election” which allows you to be taxed as an S Corp (pass-through entity) instead of a C Corp (which has its own tax rates for any retained earnings.)

Saving Payroll Taxes

The first question that should go through your head is “Why is WCI doing this?” The answer becomes very obvious once you run the numbers. With an S Corp, you get to split the money you make into “Wages” and “Distributions”. You pay payroll taxes (Social Security and Medicare) on the wages but not the distributions. You pay regular ordinary income taxes on both wages and distributions (not the lower qualified dividend rates.)

WCI now makes lots of money, and will presumably continue to
do so. So with an S Corp, we could pay ourselves salaries of perhaps $300K, then the rest can be a distribution. Since those salaries will be high enough to max out the Social Security taxes (levied on the first $127,200 in 2017), we get to save 2.9% in Medicare tax plus the 0.9% special Obamacare tax on the distribution amount. Let’s say WCI makes $800K next year. If $300K is wages, then $500K is distribution. $500K * 3.8% = $19,000. That’s why we’re doing this. $19,000 is two weeks in Italy for the entire family. Or a nice used car. Or three years of tuition at the local colleges. And it’s not like paying more in Medicare tax gives me more Medicare later (as it would with Social Security, although the “investment return” is terrible on the last few dollars you pay in SS taxes.)

Choosing a Salary

While we’re on the subject, I learned something new recently about setting your salary as an S Corp. I’ve written about this before years ago here and I had an enrolled agent point out a minor error I’ve been making for years recently in a conversation in the comments. I was more than happy to be corrected, as it’ll save me a couple thousand dollars a year in taxes now that we’re doing the S Corp thing.

Obviously, when setting your wages you want them to be as low
as possible. The lower the wage:distribution ratio, the less
you pay in payroll taxes. But there are two factors that
should motivate you to keep your wages high. The first is that
the IRS demands you pay yourself a reasonable wage. You can’t
just pay yourself $10,000 for a year’s worth of work as a
physician. So you need to have some evidence that your wages
are at the going rate. For a typical doc, a salary survey
would probably be sufficient. It may be a mistake for a doc
working full-time to have wages set below $127,500 and a good
rule of thumb to stay out of trouble with the IRS is to set
wages to at least 50% of the total profit. However, what’s a
reasonable wage for a blogger? Heck, I basically did it for
free for a couple of years and there are thousands of people
doing it for a 3-4 figure salary. So I think you can make a
pretty good case for a very low salary. Certainly setting
wages at a six figure amount seems very reasonable, even if it
is less than half the business profit.

The other factor that should motivate you to keep your wage
high is that you only include wage income when calculating how
much you can put in your retirement accounts. That’s where I
learned something new. If you’re self-employed, have an
individual 401(k), and have not used your employee 401(k)
contribution in another 401(k), (if the idea of multiple
401(k)s is new to you, click here), then your business needs
to make five times the employer contribution. If you are a
sole proprietor, it works out that you can contribute 20% of
your net income to the 401(k) as an employer contribution (in
addition to the employee contribution.) If you are an S Corp,
the corporation can contribute an amount equal to 25% of your
wage as the employer contribution. That sounds like a
different amount of business profit required to max it out,
but it really isn’t. Take a look.

An Example

Let’s assume the business makes $100K.
If it is a sole proprietorship, the employer contribution can be about 20% of that amount. (Technically it is net of the employer portion of the payroll taxes on that, but we’ll just use 20% to keep the numbers round.) So the employer contribution can be as much as $20K, in addition to the employee contribution of $18K ($24K if over 50), for a total of $38-44K.

If the business is an S Corp, it could pay you $100K in wages. (Technically it would be a little less due to the fact that the business half of the payroll taxes would have to come out first but let’s keep the numbers round.) So while the business would qualify to make a contribution of 25% of your wages ($25,000) it doesn’t actually have the money to do so, because it only made $100K and it already spent that. In fact, it doesn’t have the money to make any employer contribution to the 401(k). So what does it do? It pays you less than the total profit as wages. In fact, ideally it pays you $80K in wages and makes a $20K employer contribution to the 401(k), exactly the same as the sole proprietor.

No big deal. I’ve been aware of that for a long time. What was new to me, however, was that neither the S Corp nor the employee/shareholder pays payroll taxes on the employer 401(k) contribution. How much savings can be found there? Let’s add it up.

Smile pretty and I’ll
Let’s assume no other 401(k) and that the employee/shareholder (under 50) wants to max out an individual 401(k). For 2017, the maximum employee contribution is $18K and maximum total contribution is $54K, leaving an employer contribution of $36K. So what is the minimum wage that must be paid in order to max out the 401(k)? $36K/25% = $144K. The business still needs to make $180K (actually slightly more, but we’re ignoring the employer portion of payroll taxes) but it need only pay $144K in wages, so the employee/shareholder gets to save the Medicare tax (remember he’s already maxed out the SS tax since his wages are more than $127,200) on the difference between $180K and $144K, or about $1,044. In our case, my spouse is also an employee/shareholder, so we get to save another $1,044. $2,088 might not seem like much, but it beats a kick in the teeth.

Is $144K Really Enough?

Actually, you have to pay yourself slightly more than $144K. Here’s how I did the calculation and what we decided to do:

You want to make sure you pay yourself enough to max out your retirement accounts. In 2017, our Individual 401(k) has a limit of $54K each. If we use our $18K employee contribution in this business, that leaves an employer contribution of $36K. That can be no more than 25% of net (of the employer share of payroll taxes) salary, so that means we need a salary of at least $144K. The payroll taxes on $144K are:

- Social Security Tax of $127,500 * 6.2% = $7,905
- Medicare tax of $144,000 * 1.45% = $2,088
- Unemployment tax of $7000 * 6% = $420 (Honestly, I couldn’t really tell if this counted or not, I’m sure someone will tell me in the comments section.)
• Total of $10,413

Add $10,413 to $144K and round up a little to make the numbers round (and in case I screwed something up) and we’re going to pay ourselves $156K a piece for 2017. That works out to exactly $13K per month.

What will that save us? Well, if our salaries are $312K and our profit is $1M (optimistic but possible for this year), then our distributions would total $688K. $688K * 3.8% = $26.144 in saved Medicare tax.

The Hassle Factor

Of course, to save all this money in Medicare tax, there is going to be a price to be paid. That price is primarily additional hassle and possibly some additional expenses. Let’s look at some of the hassles and potential expenses.

1. Fill out form 2553. This form is where you elect S treatment for your corporation, or in this case, an association taxable as a corporation. Both of these forms need to be filed by March 2017 (or 75 days after the start of your corporate tax year) or you’d better have a good reason to give to the IRS for not doing it. I thought at first you also had to do an 8832, which is used to declare your LLC to be a “domestic eligible entity electing to be classified as an association taxable as a corporation,” but apparently just the 2553 is adequate. (And the IRS agreed by sending us a letter saying we’re now an S Corp.)

2. Payroll hassle. When you go from simply being a partner in a partnership to an employee of a business, the business has basically just started hiring an employee for the first time. That means it has to file lots of forms both annually and quarterly. These include forms W-2 and W-3 annually and Form 941 quarterly. This is probably in addition to the personal estimated tax forms
(1040-ES) that you were doing previously, although you could potentially increase withholding enough to make that unnecessary. In addition, I would have to start filing quarterly Utah State tax withholding forms (TC-941) and pay at least part of my Utah taxes early. (In Utah, a sole proprietor doesn’t have to make quarterly estimated payments. He can pay his entire tax bill in April.) I would also need to fill out and keep W-4s for each employee and probably produce employment contracts to legitimize the employee relationship.

3. **Corporate Tax Return.** I just learned how to do a partnership tax return last year. Now I’ve got to learn how to do a corporation one (Form 1120.) If you haven’t broken down and hired professional help with tax preparation yet, now might be a good time. I’m really looking forward to figuring out that one next year. But wait, there’s more. My state also has a corporate tax return, the TC-20.

4. **Payroll tax on child employees.** I’ve hired my kids to be models for this site. As employees of a partnership or LLC taxed as a partnership where all owners are their parents, no payroll tax is due. Plus, since it is earned income, no kiddie tax is due. Also, since I don’t pay them that much, no federal or state income tax is due. In addition, as earned income, that money can go into their Roth IRAs where it will compound tax-free for decades. Pretty sweet huh. Well, as an S Corp, neither the business nor the employee get out of those payroll taxes. It still makes sense to hire them to do legitimate work since that money would otherwise be taxed at my marginal tax rate (45%) and the total payroll tax burden for them is just 15.1%, but it is still painful to pay that extra money. There is a work around. I could create another sole proprietorship or partnership owned by me and/or my spouse (a model management or blog service company if you will), have
WCI contract with that entity, and still avoid the payroll taxes. Again, hassle versus money. On a side note, paying payroll tax on a kid that may never otherwise get 40 quarters of paying into Social Security (because they become a stay at home parent or something) may help them get to 40 quarters. Remember in 2017 it takes $1,300 of wages to get a one quarter credit for Social Security, so to get four credits WCI would have to pay the kids $5,200 a piece, which seems a little high to me for their services. Frankly, if I don’t form a blog service company, we’d be just as well off having the kids be independent contractors since the payroll taxes would have to be paid either way.

5. **Quarterly meetings.** S Corps are required to have quarterly shareholder meetings and keep minutes from them. But an LLC, even one that elects to be treated as an S Corp of tax purposes, doesn’t have to do that. One good reason to remain an LLC.

So, is all that hassle worth it to save $15K in payroll taxes? It is to me. Would I do it to save $2K? No way. A more rational person would probably spend that much just on additional accountant fees and a payroll service, not to mention the hassle.

What do you think? Is your business an S Corp? Why or why not? How do you weigh the benefits and hassles? Comment below!