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I currently file my business as a sole proprietor (Schedule C) on my individual tax return, can I consider doing something else to save taxes?

Yes, there are other options available to help you save some taxes. Right now you are paying self-employment taxes on the net profit of your Schedule C. Self-employment tax is the Social Security and Medicare you have taken out of your paycheck as an employee (currently 5.65%) but you are now the employer and also pay the employer payroll match (currently 7.65%). This is 13.3% up to the Social Security wage limit (\$110,100 for 2012) until 12/31/12 after which the rate will return to 15.3% if there are no further legislative changes (the talk is the President is looking to extend this further).

The best thing for you to do is create a separate legal entity with the state to start reporting your business activity in this entity. You can create an LLC or Corp but confer with legal counsel on which is best suited for your business. You would then need to elect to become a federal S-corporation (by filing Form 2553 within 2 ½ months of formation of the entity). Once you start operating your business from this new entity, you instantly save the self-employment taxes; however, keep in mind that you still need to pay yourself a “reasonable” salary in order to avoid any potential IRS entanglements. Please consult your tax counsel on what is the best “reasonable” salary for you as this can be different amount for each business.

You would still be paying the “self-employment” tax per se in your S-corporation to the extent you are paying yourself a “reasonable” salary, but it can significantly reduce your overall tax bill. This process generally works best if you are earning a net profit of \$50,000 or more (or expect to earn this kind of profit in the future). Keep in mind that you now have a separate tax return, separate business licenses, and annual state filing fees that may cost you \$1,000 to 2,000 or more each year, but you could be saving \$3,325 in self-employment tax on \$25,000 of profit (after your salary). This would net you a \$1,000-2,000 in tax savings. The savings become even greater if your profit is even higher.

If you have a tax or accounting question, please email dan@danhenncpa.com.