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Thread: [How to save on taxes \(self-employed\)](#)

TrueKings - December 31, 2020, 9:16 am

As an entrepreneur the number one worry we have – especially once our business begins to take off – is our tax burden. If you are operating your small business under an LLC, there is a very good chance that you will be paying more in taxes than friends of yours who are making the same annual income. Why is this the case?

Well, unlike your standard job where you are an employee, you have to cover both halves of your FICA taxes. We call this self-employment tax. Yes, you are in a sense punished for going out on your own and becoming self-employed. Beyond just this, your goal as an entrepreneur is to earn as much revenue as possible throughout the year. Your earnings are not capped. This means that you have a potentially unlimited tax bill coming at the end of the year. The only way to really protect yourself against this is by saving at least 30% of your earnings in an account for taxes at the end of the year. This is money that you could be using to grow your business further, but instead it is sitting in an account. Hopefully, at the very least it is sitting in a High Yield savings account so it can at least return you a small amount, but that is in no way the most efficient method.

Thankfully, there are options for people in this exact situation. If you consistently make over \$50,000 annually, it may be a good to transition your LLC into an S corp. (You will want this transition to start with an LLC. If you start with a sole proprietorship, all your payments over the year will have been made to you personally, rather than the business. This will cause problems when it comes to the accounting of the business. So why is an S Corp the better option for people of this size?

Taxes! There are only three reasons one would want to set up a corporate structure.

Minimization of liability

Access to capital

More efficient tax treatment

Now, like most things. If you look at corporate structures on their face, it is very much a “you can’t have your cake and eat it too” sort of setup. Now, there are ways around those limitations, but that isn’t something we are going to go into here. For an S Corp, we get the same liability protections as an LLC. You can get some limited extra access to capital as you can have up to 100 shareholders, but honestly, if raising capital is your #1 concern, you’re likely better off in a C corp. Where the S corp truly shines is in how that structure is treated when tax season comes around. Much like an LLC, an S corp can be viewed as a passthrough entity – so all earnings are eventually passed onto its shareholders. The magic is in HOW those earnings are passed on.

As a corporation, your company is now its own entity. You are no longer the company. Rather, you are an employee of the company that you own. Due to this, you can assign yourself a salary. You’ll want this salary to be as small as physically possible. (You will still need to pay yourself a salary that the IRS deems as “reasonable” for your position.) Here’s why – On that salary you will owe all of your standard income taxes – though you can have your company pay half of the FICA taxes. But

YOU get to control what your effective tax rate is. Say you make \$100,000 this year. You pay yourself \$50,000. On that \$50k you pay your income taxes. What happens to the other \$50,000? Well, These funds still pass onto you. However, instead of passing to you in the form of income, like they would under an LLC, they pass on as qualified dividends. Under current regulations, qualified dividends are taxed at the long-term capital gains rates - 15%. (This percentage jumps up to 20% once you make more than \$479,600/year). So, instead of paying income taxes on all of your earnings, you just pay those taxes on your salary, and the rest of your income is taxed at a much lower rate.

Below is a table outlining the difference in tax treatment between being an LLC or an S Corp on an income of \$87,500. There are more ways to save on taxes beyond this structure, but, let's just take it one step at a time.

	Comparison	
	LLC	S Corp
Taxable Income	\$87,500.00	\$50,000.00
Taxable Distributions	0	\$37,500.00
Year End Cash	\$51,585.50	\$65,387.50
Total Taxes Owed	\$35,914.50	\$22,112.50
Effective Tax Rate	35.91%	22.11%

MartyMcFly - January 1, 2021, 11:49 am

Thanks for this high quality post! This is valuable knowledge many users might not know about. I will add a note that you can always elect to treat your LLC as an S Corp for tax purposes. This might be simpler for those that don't want the added expense and hassle of managing a corporation.