THE NAUTILUS GROUP®



Making an S Election to Minimize Self-Employment Taxes

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Employment Taxes – In General

Owners of businesses taxed as sole proprietorships or partnerships are generally responsible for self-employment taxes, which include Social Security tax (12.4%) on income up to $176,100 for 2025, and Medicare tax (2.9%) on all income, with no cap. Because these business owners are considered both employer and employee, they pay the full 15.3% self-employment tax themselves. However, they may deduct one-half of the self-employment tax when calculating their federal income tax. Additionally, high-income individuals are subject to an additional 0.9% Medicare surtax on wages or self-employment income exceeding $200,000 ($250,000 for married taxpayers).

How S Corporations Are Different

Owners of S corporations pay employment taxes only on the wages they receive from the business, not on the business's entire net income. This allows owners to potentially reduce their self-employment tax liability—provided the wages paid are considered "reasonable compensation" under IRS standards.

Determining a Reasonable Salary

The IRS requires S corporation owners to pay themselves a reasonable salary for services rendered. In determining a reasonable salary, you should consult with an accountant or local counsel. Factors to consider when determining a reasonable salary include:

- The volume, complexity, and profitability of the business
- The owner's role, responsibilities, and hours worked
- Local wage standards and industry compensation levels
- Salaries of non-owner employees and past compensation history
- Company policy and distribution patterns

The IRS does not publish specific figures, but salaries should be benchmarked against market compensation for similar roles and responsibilities. If the IRS determines that the compensation is unreasonably low, they may reclassify all or part of the corporate distributions as wages and impose additional payroll tax liability.

Example: Potential Tax Savings with an S Election

Assume your business generates $500,000 in net income and is currently taxed as a sole proprietorship or an LLC taxed as such. You file jointly and a reasonable salary for someone in your line of work is $100,000 annually earn a reasonable market salary of $100,000.

Without an S Election (Sole Proprietor Treatment)

As a sole proprietor, the entire $500,000 net income is subject to self-employment tax:

- Social Security tax (12.4%): $176,100 × 12.4% = $21,852.40
- Medicare tax (2.9%): $500,000 × 2.9% = $14,500.00
- Additional Medicare tax (0.9%): $250,000 × 0.9% = $2,250.00
- Total self-employment tax: $21,852.40 + $14,500.00 + $2,250.00 = $38,602.4

With an S Election

With S corporation status, only the $100,000 salary is subject to employment taxes:

- Social Security tax (12.4%): $100,000 × 12.4% = $12,400.00
- Medicare tax (2.9%): $100,000 × 2.9% = $2,900.00
- Additional Medicare tax (0.9%): Not applicable, as salary is below the $250,000 threshold.

Example

- Total employment tax: $12,400.00 + $2,900.00 = $15,300.00
- Estimated tax savings: $23,302.40

This is only an estimate and should not be relied upon as it relates to your actual return; accordingly, please consult your own professional tax advisor. This estimate assumes that the IRS would consider $100,000 a reasonable salary and that all remaining business profits are treated as S corporation distributions not subject to employment tax. Actual savings depend on your tax situation.

Example

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