

S-CORPORATION TAX STRATEGIES 101



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Home Office

As an S-corporation owner you are an employee of your business. As an employee certain expenses you incur personally such as the use for your home for business. To qualify for the deduction your employee use of a home office is for the convenience of your S corporation employer when your facts and circumstances satisfy any one of the following:

- You must maintain the home office as a condition of employment.
- Your home office is necessary for the functioning of the S corporation's business.
- The home office is necessary to allow you to perform your duties properly.

You will generally want to keep a statement on file that specifies this for the business, and you update it annually.



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Here are some steps to properly claim the home office deduction:

1. As an employee of your corporation, you submit expense reports to your corporation for the expenses of your home office.
2. The corporation reimburses you for the home office and claims 100 percent of the homeoffice deduction as office space.
3. You receive the reimbursement as reimbursed employee business expenses. Such employee reimbursements are not taxable to you.



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When you submit the expense to the S Corporation here is the proper procedure for documentation:

1. Proof of the expense (e.g., photocopy of the utility bill)
2. Proof of exclusive use (e.g., attesting to exclusive use; photo of exclusive use setup)
3. Proof of regular use (e.g., attesting to regular use; submitting a document with hours of use)
4. Proof of business use (e.g., adding the type of business use to the hours of use document)
5. Proof that your employee use of the home office is for the convenience of your S corporation employer.



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On the Tax Return

On the S corporation tax return, report the total reimbursement of the home office in the other deductions category in a line item labeled “office space” or something similar.

On your personal tax return, reduce your itemized deductions by the dollar amounts you received as reimbursements from the S corporation for the home-office mortgage interest and property taxes.

In the permanent file that you maintain for your personal taxes, make sure to track the straight-line depreciation that the corporation reimburses to you for the home office. You need to treat this depreciation as if you claimed it personally. This means the depreciation reduces your basis in the home.

This also means that at the time of sale, the straight-line depreciation reimbursed to you is subject to taxation of up to 25 percent as unrecaptured Section 1250 gain.



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Salary

As an employee you also will pay yourself a salary. Many new owners get hung up on the term "salary" because they equate that with "paying themselves" or a "higher salary is better". However, in the S-Corp world a lower salary is more preferred since you pay 15.3% tax on whatever you take in salary. The remaining profit of the business is exempt from this 15.3% tax.

- How we got the 15.3% is from your share of social security and Medicare taxes
- You pay SSI taxes of 12.4% on the first \$147K of salary(2022) and you pay Medicare taxes of 2.9% on your entire salary. You will pay an additional .9% of Medicare tax on salary above \$200K single and \$250K Married



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Now before you get too excited and want to set your salary at \$0. The IRS states this salary has to be “reasonable”. If they deem your salary to be too low they can audit your business and adjust your salary upwards costing you additional taxes and penalties. The tricky part is in the IRS’s own words, “There are no specific guidelines for reasonable compensation in the Code or the Regulations. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of each case.”



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What the IRS did do however was list some guidance in a job aid as to the approach you can take for your salary.

The 3 approaches listed are:

1. Market approach - The market approach to reasonable compensation compares the S corporation's business with others and then looks at the compensation being paid by those businesses to employees who look like you. In other words, how much compensation would be paid for this same position, held by a non-owner in an arm's-length employment relationship, at a similar company?

One specific court case an S-Corp owner of a CPA was made to pay self \$91K in salary and a profit distribution of \$155K for a 37% salary to profit ratio.



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2. Income approach – The income approach is based on the independent investor test, which means the salary of the owner can only be applied correctly when the fair market value of the company is available for each year that compensation is being examined. Generally this will involve C-corporations or S-Corporations who have outside investors.
3. Cost approach - The cost approach breaks your employee activities into their components, such as management, accounting, finance, marketing, advertising, engineering, purchasing, janitorial, bookkeeping, clerking, etc. You can break out the individual jobs that you complete as an owner and the hourly rate that would command.



Here is an example:

| TASK | HOURS | RATE | TOTAL |
|-----------------|-------|------|----------|
| Driver | 100 | \$13 | \$1,300 |
| Sales Rep | 800 | \$25 | \$20,000 |
| Marketing Rep | 500 | \$25 | \$12,500 |
| Administrative | 300 | \$17 | \$17,600 |
| Accounting | 80 | \$22 | \$1,760 |
| General Manager | 300 | \$40 | \$12,000 |
| Total | 2080 | | \$65,160 |



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Health Insurance

If you own more than 2 percent of an S corporation, you need to follow three steps to deduct your health insurance premiums.

Step 1. Get the cost of the insurance on the S corporation's books. To do this, the S corporation first establishes a health insurance plan for you in one of two ways:

- The S corporation makes the premium payments for the accident and health insurance policy covering you (and your spouse or dependents, if applicable).
- You make the premium payments to the insurance company and then furnish an expense report with proof of the premium payments to the S corporation, which in turn reimburses you for the premium payments.



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Step 2. The S corporation includes the health insurance premiums on your W-2 as taxable income. But this income is not subject to payroll taxes (Social Security and Medicare). In other words, the S corporation includes the additional compensation in box 1 of the W-2 but not in boxes 3 or 5.

Step 3. You claim the health insurance deduction as an above-the-line self-employed health insurance deduction on Form 1040, provided you otherwise qualify for the deduction by overcoming the two hurdles below.



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You have two qualification hurdles to claiming the self-employed health insurance deduction on your Form 1040:

- You cannot take this insurance deduction if you or your spouse is eligible for employer subsidized health insurance. Thus, if your spouse can get family health insurance as a tax advantaged fringe benefit through his or her employer, you lose your eligibility for this deduction—even if your spouse does not actually accept the employer-sponsored insurance.
- Your deduction for the insurance premiums cannot exceed the amount of your salary from the S corporation.



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Why this is important for family members is because your spouse, children, grandchildren and parents are deemed to own the same % of the S-corporation as you do based on the attribution rules in Tax code Section 318.

Therefore, if any of these family members work for you, even if they have no direct ownership, you would need to include the health insurance premiums in their wages the same way you include them for yourself the owner. The S-Corporation would then deduct the expense as a salary expense instead of a health insurance expense.



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Retirement Accounts

The S corporation's employer contributions on behalf of the owner-employee to a defined benefit plan, simplified employee pension (SEP) plan, or 401(k) count as compensation but don't trigger payroll taxes.

Such contributions further enable the savings on payroll taxes while adding to the dollar amount that's considered reasonable compensation.

Important: Your S corporation compensation determines the amount that your S corporation can contribute to your SEP or 401(k) retirement plan.



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Section 199A Deduction

The S corporation's net income that is passed through to you, the shareholder, can qualify for the 20 percent Section 199A tax deduction on your Form 1040.



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Other Deductions Available:

Travel Expenses

An S corporation owner who incurs business-related travel expenses must submit an expense report and be reimbursed by the S corporation. Receipts are needed for expenses of \$75 or more.

Vehicle

Business use of your automobile are deductible through reimbursements from the S-Corporation. As an employee you must prove the business use of the vehicle (with a mileage log for 3 months or a one week log for 12 weeks out of the year), and have receipts for expenses of \$75 or more.

The business can reimburse you through the miles you drive (58.5 cents per mile Jan-June 2022 and 62.5 cents per mile July-Dec) or through depreciation plus the actual expenses you incur for using the vehicle. You will need to adjust the actual expenses based on the % of business use you have for the vehicle.



Phone

When an S corporation provides an employee with a smartphone or similar telecommunications equipment primarily for non-compensatory business reasons, this is considered a working condition fringe benefit that is excludable from income.

The S corporation can reimburse the employee for the full cost of the phone expenses (including the personal use) and deduct this amount on the corporate tax return. The reimbursement is tax-free income to the employee.



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Primary Residence

If you plan to convert your personal residence into a rental property, consider first selling the home to your S corporation. You can avoid taxes on the sale with the Section 121 home sale exclusion of \$250,000 gain (\$500,000 if married). Additionally, you increase the rental property's depreciable basis, which provides for greater depreciation deductions.

Your S-corp can also rent your entire home up to 14 days a year and receive tax benefits. The S corporation deducts the full amount of the rent, and the owner realizes the income completely free of income tax under section 280.



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Child Workers

You can employ your children (for legitimate task at a reasonable wage) and pay them up to \$12,950, in 2022 without them having to file a tax return. The S-corporation will have to pay payroll taxes on behalf of your child. Make sure to keep a log of hours, send them a W-2 and pay the money to an account they are an owner on.

You can get around paying the payroll taxes (for minors under 18) if your S-Corporation pays a management company(that you own) a fee to manage the HR for your business. That management company (a sole proprietor) pays your child the wages owed to the them (with the fee collected) and the sole proprietorship is not required to pay payroll taxes.

