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## S Corporation/Loan-Out v. Employee, Which is Better Tax Wise?

A question that we are often asked is whether a client should incorporate or keep getting paid as an employee? In our practice, majority of our clients are incorporated and for a good reason. They end up paying less taxes!

Approximately 80% of our clients are in the entertainment industry. In the entertainment industry it is common for the talent, whether in front or behind the camera, to work through his or her corporation. When they work through their corporation, their corporation is referred to as a "loan-out". The term loan-out means that the corporation is loaning out the services of the talent to the production or studio or to whomever needs that service. That's where the term loan-out comes from. The remaining 20% or so of our clients are either dentists, doctors, in real estate or attorneys.

What is discussed below is applicable to most professions and industries. It is not specific to one profession or industry.

Furthermore, about 99% of our clients that are some type of entity are actually S Corporations. S Corporations have many advantages. For the sake of keeping this article somewhat simple, we're only referring to S Corporations in our comparison and examples. The analysis below would also be applicable to a Limited Liability Company (LLC) and partnerships as well to a certain extent. The one big difference is you, your spouse or children can be the employees of your own S Corporation. This is not true for LLCs and partnerships.

The following are comparisons of what benefits, advantages or disadvantages are afforded as an employee versus an S Corporation/loan-out:

1. **AB 5, Worker Status**
   As an employee, you don't need to worry about it because you're being treated as an employee.

   As an S Corporation, it depends on whether the client, production, company, studio and etc. is willing to pay your corporation or prefers to pay you as an employee.

2. **Employer Benefits – Health Insurance, Retirement Plan, Dependent Care, Flexible Spending Account, Health Savings Account & Etc.**
   As an employee, your employer may offer the above benefits that you can take advantage of.

   As an S Corporation, you have to pay for the above benefits yourself. However, you will receive a deduction for it and what happens if your employer doesn't offer the benefit that you want or need? Then there may not be much that you can do. However, as an S Corporation you can implement most benefits for you and your family and get a tax deductions for it too.

3. **Books & Records**
As an employee, you don't really need to keep any books and records because for federal tax purposes employee business expenses are not deductible. They are for California purposes.

As an S Corporation, you do need to keep separate books and records. Which could mean additional time and costs such as a bookkeeping fees.

4. **Corporate Tax**
As an employee, it is not applicable.

As an S Corporation, you have to pay California the greater of $800 or 1.5% of the corporation's net income. Additional tax that you don't pay being an employee.

5. **Covid 19 Related Programs Such as the SBA EIDL Grant, SBA EIDL Loan, SBA PPP Loans, Employee Retention Credit, Various California Grants, Various IHSS Grants & Etc.**
As an employee, unfortunately you do not qualify for any of the above programs and or the free money some of them provided.

As an S Corporation, you would basically qualify for most if not all of them. Also, you never know when more governmental programs like the ones above may be available in the future. It would be wise to be ready for them now.

6. **Incorporating Costs**
As an employee, it is not applicable to you.

As an S Corporation, there is a one-time fee to get incorporated. There are a lot of online companies that can incorporate you. We can also incorporate you.

7. **Pass-Through Entity Elective Tax (PEET) or Also Known as the Pass-Through Entity Tax (PET) or the SALT Workaround or AB 150**
As an employee, it is not available to you.

As an S Corporation, you are able to deduct more than $10,000 in state taxes against your personal federal taxable income. Also, it completely bypasses the Alternative Minimum Tax (AMT) calculation which takes into account personal taxes paid.

8. **Qualified Business Income (QBI) Deduction**
   As an employee, it is not available to you.

   As an S Corporation, if your entity qualifies for it then 20% of your entity's net income tax free for federal tax purposes.

9. **Social Security & Medicare Taxes**
   As an employee, you only pay your half of social security, 6.2%, and Medicare, 1.45%, taxes which in total is 7.65%. You pay social security tax, 6.2%, on the first $147,000 of your salary. Then it stops. There is no limit for Medicare.

   As an S Corporation, you end up paying double in social security, 12.4%, and Medicare, 2.9%, because you are the employer and employee. However, you can somewhat control the amount of salary that you receive. Therefore, you can somewhat control the total social security and Medicare taxes that you will end up paying.

   Also, as an S Corporation, you can control the amount of salary that you get. Therefore, if it's less than $200,000 you will not pay the additional .9% Medicare Tax.

   Finally, as an S Corporation, you do not pay any social security or Medicare taxes on the net income of the corporation.

10. **Retirement/Solo 401(k) Plans**
    As an employee, if your employer provides a retirement plan you have to participate through it. If your employer does not provide a retirement plan the best that you can do is to contribute to a Traditional or Roth IRA. The maximum is $6,000 if you're 49 or younger and $7,000 if you are 50 or older.

    As an S Corporation, you can set-up any type of retirement plan that you wish. We prefer Solo 401(k) plans for many reasons. You can contribute a significant amount to it with a relatively small salary.

11. **Tax Returns**
    As an employee, you only file one tax return; personal federal and state(s) returns.

    As an S Corporation, you would need to file S Corporation tax returns as well along with quarterly and annual payroll tax returns. Which means additional professional fees and costs.

12. **Taxable Wages/Income**
    As an employee, you pay taxes on your gross taxable wages. You cannot

write off any employee business expenses for federal tax purposes. You can for California. Therefore, if your gross taxable wages is $200,000, then you're paying federal and California personal taxes on $200,000

As an S Corporation, you pay taxes on the corporation's net income, not gross. For example, if your corporation grosses $200,000 and has $50,000 business expenses then you end up paying taxes on $150,000, not $200,000.

Business expenses can be anything that are ordinary and necessary costs incurred to operate your business. Such as advertising, automobile (gas, insurance, repairs, DMV, car washes, lease payments, interest, depreciation & etc.), computer expenses & fees, health insurance, other insurances, dues & subscriptions, internet fees, licenses & permits, office supplies & expenses, production expenses, professional & legal fees, rent, home office expenses (such as utilities, insurance, repairs, mortgage interest, property taxes, depreciation & etc.), salaries & wages, payroll taxes, corporate taxes, telephone, research, business meals, union dues, commissions, marketing, uniforms, business travel and etc. Also, retirement plans and pension contributions.

Now, we'll try to makes sense of what all the above mean by providing you with various examples.

**Example 1**: Assume Sara and Nick are both editors. They both work for the same production company and make $200,000 a year. Both work from home. Sara creates an S Corporation/loan-out for herself and starts getting paid through it. Nick remains as an employee. Assume they both have $30,000 of business expenses, not including retirement contribution and what they do qualifies for the Qualified Business Income deduction.

| | Sara | Nick |
|---|---|---|
| Gross Income | $200,000 | $0 |
| Less Expenses: | | |
| Business Expenses | 30,000 | 0 |
| Salary | 50,000 | 0 |
| Total Expenses | 80,000 | 0 |
| S Corporation's/Loan-Out's Taxable Income | $120,000 | $0 |
| Personal Income/Expenses: | | |
| Salary | $50,000 | $200,000 |
| S Corporation's/Loan-Out's Taxable Income | 120,000 | 0 |
| Less Qualified Business Income Deduction | -24,000 | 0 |
| Less Standard Deduction | -12,950 | -12,950 |

| | | |
|---|---|---|
| Personal Federal Taxable Income | $133,050 | $187,050 |
| Tax Cost: | | |
| Social Security - Employee | $3,100 | $9,114 |
| Social Security – Employer | 3,100 | 0 |
| Medicare – Employee | 725 | 2,900 |
| Medicare – Employer | 725 | 0 |
| Employer Taxes Such as FUTA, SUI & ETT | 287 | 0 |
| CA S Corporation Tax | 1,800 | 0 |
| Federal Personal Tax | 25,768 | 40,088 |
| State Personal Tax | 12,366 | 13,184 |
| Total Taxes | $47,871 | $65,286 |

Sara ends up paying $17,415 less in taxes versus Nick.

**Example 2**: Same facts as example 1 above. However, Sara sets up a Solo 401(k) plan and contributes the maximum to it. Based on her salary of $50,000, she defers $19,500 of her salary to her 401(k) and her corporation makes an employer contribution of $12,500, 25% of her salary.

| | Sara | Nick |
|---|---|---|
| Gross Income | $200,000 | $0 |
| Less Expenses: | | |
| Business Expenses | 30,000 | 0 |
| Salary | 50,000 | 0 |
| Employer Pension Contribution | 12,500 | 0 |
| Total Expenses | 92,500 | 0 |
| S Corporation's/Loan-Out's Taxable Income | $107,550 | $0 |
| Personal Income/Expenses: | | |
| Salary | $50,000 | $200,000 |
| S Corporation's/Loan-Out's Taxable Income | 107,500 | 0 |
| Less Qualified Business Income Deduction | -21,500 | 0 |
| Less 401(k) Deferral | -19,500 | 0 |
| Less Standard Deduction | -12,950 | -12,950 |
| Personal Federal Taxable Income | $103,500 | $187,050 |
| Tax Cost: | | |
| Social Security – Employee's Share | $3,100 | $9,114 |
| Social Security – Employer's Share | 3,100 | 0 |
| Medicare – Employee's Share | 725 | 2,900 |
| Medicare – Employer's Share | 725 | 0 |
| Employer Taxes Such as FUTA, | | |

| | | |
|---|---|---|
| SUI & ETT | 287 | 0 |
| CA S Corporation Tax | 1,613 | 0 |
| Federal Personal Tax | 18,688 | 40,088 |
| State Personal Tax | 9,390 | 13,184 |
| Total Taxes | $37,628 | $65,286 |

Sara ends up paying $27,658 less in taxes versus Nick.

**Example 3**: Same facts as example 2 above. However, Sara takes advantage of the pass-through entity elective tax (PEET, PET or SALT Workaround). Assuming her corporation's California net income in 2021 was $80,000 as well, her PEET payment for 2022 would be $7,440. Thus, she would reduce her 2022 federal taxable income by $7,440.

| | Sara | Nick |
|---|---|---|
| Gross Income | $200,000 | $0 |
| Less Expenses: | | |
| Business Expenses | 30,000 | 0 |
| Salary | 50,000 | 0 |
| Employer Pension Contribution | 12,500 | 0 |
| PEET Payment | 7,440 | 0 |
| Total Expenses | 99,940 | 0 |
| S Corporation's/Loan-Out's Taxable Income | $100,060 | $0 |
| Personal Income/Expenses: | | |
| Salary | $50,000 | $200,000 |
| S Corporation's/Loan-Out's Taxable Income | 100,060 | 0 |
| Less Qualified Business Income Deduction | -20,012 | 0 |
| Less 401(k) Deferral | -19,500 | 0 |
| Less Standard Deduction | -12,950 | -12,950 |
| Personal Federal Taxable Income | $97,598 | $187,050 |
| | | |
| Tax Cost: | | |
| Social Security – Employee's Share | $3,100 | $9,114 |
| Social Security – Employer's Share | 3,100 | 0 |
| Medicare – Employee's Share | 725 | 2,900 |
| Medicare – Employer's Share | 725 | 0 |
| Employer Taxes Such as FUTA, SUI & ETT | 287 | 0 |
| CA S Corporation Tax | 1,613 | 0 |
| Federal Personal Tax | 17,259 | 40,088 |
| State Personal Tax | 9,390 | 13,184 |
| Total Taxes | $36,199 | $65,286 |

Sara ends up paying $29,087 less in taxes versus Nick.

**Example 4**: Same facts as example 3 above. However, Sara has a 13 year old daughter. She helps Sara out with editing, office and computer stuff. Sara's corporation hires her during the summer months and pays her a $12,000 salary. Assume that Sara does not claim her daughter as a dependent and still files as single.

| | Sara | Nick |
|---|---|---|
| Gross Income | $200,000 | $0 |
| Less Expenses: | | |
| Business Expenses | 30,000 | 0 |
| Salary | 50,000 | 0 |
| Employer Pension Contribution | 12,500 | 0 |
| PEET Payment | 7,440 | 0 |
| Daughter's Salary | 12,000 | 0 |
| Total Expenses | 111,940 | 0 |
| S Corporation's/Loan-Out's Taxable Income | $88,060 | $0 |
| Personal Income/Expenses: | | |
| Salary | $50,000 | $200,000 |
| S Corporation's/Loan-Out's Taxable Income | 88,060 | 0 |
| Less Qualified Business Income Deduction | -17,612 | 0 |
| Less 401(k) Deferral | -19,500 | 0 |
| Less Standard Deduction | -12,950 | -12,950 |
| Personal Federal Taxable Income | $87,998 | $187,050 |
| | | |
| Tax Cost: | | |
| Social Security – Employee's Share | $3,100 | $9,114 |
| Social Security – Employer's Share | 3,100 | 0 |
| Social Security for Daughter – Employee's Share | 744 | 0 |
| Social Security for Daughter – Employer's Share | 744 | 0 |
| Medicare – Employee's Share | 725 | 2,900 |
| Medicare – Employer' Share | 725 | 0 |
| Medicare for Daughter – Employee's Share | 174 | 0 |
| Medicare for Daughter – Employer's Share | 174 | 0 |
| Employer Taxes Such as FUTA, SUI & ETT | 287 | 0 |
| Employer Taxes Such as FUTA, SUI & ETT for Daughter | 287 | 0 |

| | | |
|---|---|---|
| CA S Corporation Tax | 1,433 | 0 |
| Federal Personal Tax | 14,977 | 40,088 |
| State Personal Tax | 7,582 | 13,184 |
| Total Taxes | $34,052 | $65,286 |

Sara ends up paying $31,234 less in taxes versus Nick.

**Example 5**: There is another pandemic and the government reinstates the SBA PPP loan and the Employee Retention Credit (ERC). Assume that Sara's corporation qualifies for the ERC for two quarters and for the SBA PPP loan for the other two quarters. Sara would receive a PPP loan for the amount of approximately $10,417 and she would receive the ERC for approximately $14,000. Both would be possibly tax free and would not have to be repaid back. Thus, she would get basically $24,417 for the fact that she was an S Corporation and Nick would not receive anything. She would most likely qualify for the SBA EIDL Loan as well. However, that would need to be repaid back but has very favorable terms.

The above examples are not hypothetical. They're actual scenarios from our clients. These are real life cases.

The material stated above has been prepared for informational purposes only. What is stated above is what we know as of today. It can change anytime or when additional guidance/information is released and it could be different and/or contradict what is stated above. We are not responsible for any changes, errors or misinformation from what is stated above.

If you have any questions or need additional information, please do not hesitate to call us at 310.479.7020.

Very truly yours,

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