THREE OAKS
WEALTH
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Four Easy Ways for Business Owners to Save Money on Taxes

One of the most common refrains I hear from business owners when it comes to their personal finances is a desire to pay less in taxes. Simply put, the less you pay in taxes, the more you get to keep for yourself.

Given the nuances and complexities of our tax code, there is substantial opportunity for business owners to plan proactively and ultimately reduce the amount they owe in taxes.

This guide will examine four strategies commonly available.

01 Reevaluate Your Business Structure

Many business owners begin their operations as a sole proprietorship, partnership, or LLC, and never look back. This is a mistake. Your business will likely evolve substantially over its life cycle, and the best form of organization on day one may not be optimal even a few years later.

Most businesses start out as "pass through business entities", meaning that business profits and tax responsibilities are "passed through" pro rata to the owners. Each owner is then responsible for paying taxes on these profits based on their personal tax bracket, which currently tops out at 37%.

When you're the only owner, such as in a sole proprietorship or single member LLC, all revenues, expenses and earnings are reported on your personal tax return. Owners of partnerships and multi-member LLCs are still responsible for paying taxes on earnings, but the business produces its own tax documents. Profits are then distributed back to each owner on a K-1 tax form.

C-corporations pay taxes at the entity level. The current tax code offers a flat 21% tax rate to corporations, which is obviously less than the top bracket of 37% that many individuals fall into.

Does that mean you should reorganize tomorrow as a C-corporation to pay 21% on business profits instead of 37%? Not quite.

To level the playing, the IRS offers a 20% deduction on qualified business income in some circumstances. It may be the case that your business is better off as an S-corporation after accounting for this deduction. It may also be the case that you're ineligible for the deduction for a variety of reasons, and organizing as a C-corporation would indeed save you money.

The tax code is complex, and this is an overly simplistic example. But the point remains the same: reevaluating your form of organization periodically can yield substantial tax savings. And since your business will likely change and evolve over time, a different entity structure may offer a better foundation for you to build on

02 Contribute to a Retirement Plan

Setting up a retirement plan through your business may be the lowest hanging fruit when it comes to tax planning. Since the IRS wants us all to save for retirement, they offer tremendous tax advantages when making contributions to retirement plans like 401(k)s, SEP-IRAs, and SIMPLE IRAs. Specifically, every dollar you or your business contributes to such a plan is either deductible or excluded from your taxable income entirely.

The catch is that the government wants these plans to be equitable. While they want us all to save for retirement, they don't want businesses to set up plans that benefit ownership more than the employees. For this reason, "qualified" retirement plans like 401(k) plans are required to undergo compliance testing each year to confirm that the scales are balanced.

There are many types of retirement plans available, and the best choice for one business may be different than the best choice for another. The main types we see businesses utilize are SEP-IRAs, SIMPLE IRAs, and 401(k) plans. Each has unique rules and responsibilities. While 401(k) plans offer more flexibility and opportunity to customize, it also comes with more compliance requirements and oversight.

Regardless of which retirement plan might be the best fit for your business, the math remains the same. Any dollar contributed to a retirement is one less dollar you need to pay taxes on each year. Structuring the best retirement plan for you and your business's needs can help dramatically reduce your tax bill.

03 Hire Your Kids

A very underutilized tax strategy is to hire your kids. Picture this: you make $300,000 per year in your business, which would put you in the 24% tax bracket if you're married. You have a teenage daughter living with you who has her driver's license and drives to and from school every day. You pay for her gas and insurance.

Let's now say that you hire your daughter part time at your business. She makes $15 per hour to sweep the floors and do some filing, and through-out the year pulls in $6,000 total.

Since your daughter makes less than the standard deduction (currently $12,950), she will not pay any federal income taxes on her earnings. In fact, she doesn't even need to file a tax return if she doesn't want to! (She may want to anyway, for a number of different reasons).

Assuming your business revenue hasn't changed, you've effectively reduced your income by $6,000 to $294,000, and directed it to your daughter. Whereas you'd be paying 24% federal income taxes on the $6,000 if you kept it for yourself, it'll come in to the family income tax free by directing it to your daughter.

On top of all this, the earned income qualifies your daughter to contribute to a Roth IRA – again tax free. You could even make this contribution on her behalf, as she doesn't necessarily need to be the party depositing the cash.

Suffice it to say that hiring your kids can have substantial tax benefits. It should not be done lightly though. If you decide to put your kids on payroll be sure that they're being hired to a bona fide position and are being compensated fairly for their work. While you could justify paying your daughter $15 per hour to sweep the floors and file, paying her $100 per hour would not fly.

04 Pay Yourself Properly

As mentioned above, pass through businesses like sole proprietorships, partnerships, and LLCs have little discretion as far as how owners are compensated. You total up company revenues, subtract expenses, and are left with profits that the owners pay taxes on.

Not so with corporations. With corporations, both S-corps and C-corps, owners are expected to be paid w-2 wages commensurate with their efforts in the business. The amount you pay yourself has tax implications, offering another saving opportunity. For s-corporations, owners are responsible for the taxes due on any profits remaining after wages and other expenses.

Here’s an example:

You run a local business that produces $150,000 per year in revenues and has $50,000 in operating expenses, not including your own compensation. If this company were a sole proprietorship or an LLC, you’d have $100,000 of self-employment income to pay taxes on.

If it were an S-corporation, you’d need to pay yourself a w-2 wage – let’s say $50,000. The other $50,000 remaining would be considered business profits. While you’d pay the same level of income tax on your wages AND business profits, the business profits are not subject to payroll & FICA taxes for Social Security and Medicare.

In general, the more you take out as business profits and the less you take out as w-2 wages, the lower your tax liability. The more you take out as w-2 wages, the more you pay in taxes.

On top of all this, the IRS requires owners of S-corporations to pay themselves a “reasonable wage”. While you can reduce your tax bill by reducing your w-2 wages, you may not reduce those wages all the way to $0. You must pay yourself reasonable w-2 wages based on your duties, responsibilities, and other industry specific benchmarks. Adjustments in your w-2 compensation will also have an impact your Social Security benefit accrual.

Summary

Like all tax planning, the best way for you to reduce your tax bill will depend on your specific circumstances. The four tactics described here may be good opportunities for you & your business, they may not be. The key is to plan proactively. Your accountant and financial planner should be equipped to help you assess the best strategy for your situation. Remaining proactive and optimizing where possible can help you reduce your tax bill in alignment with your business & personal needs.

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