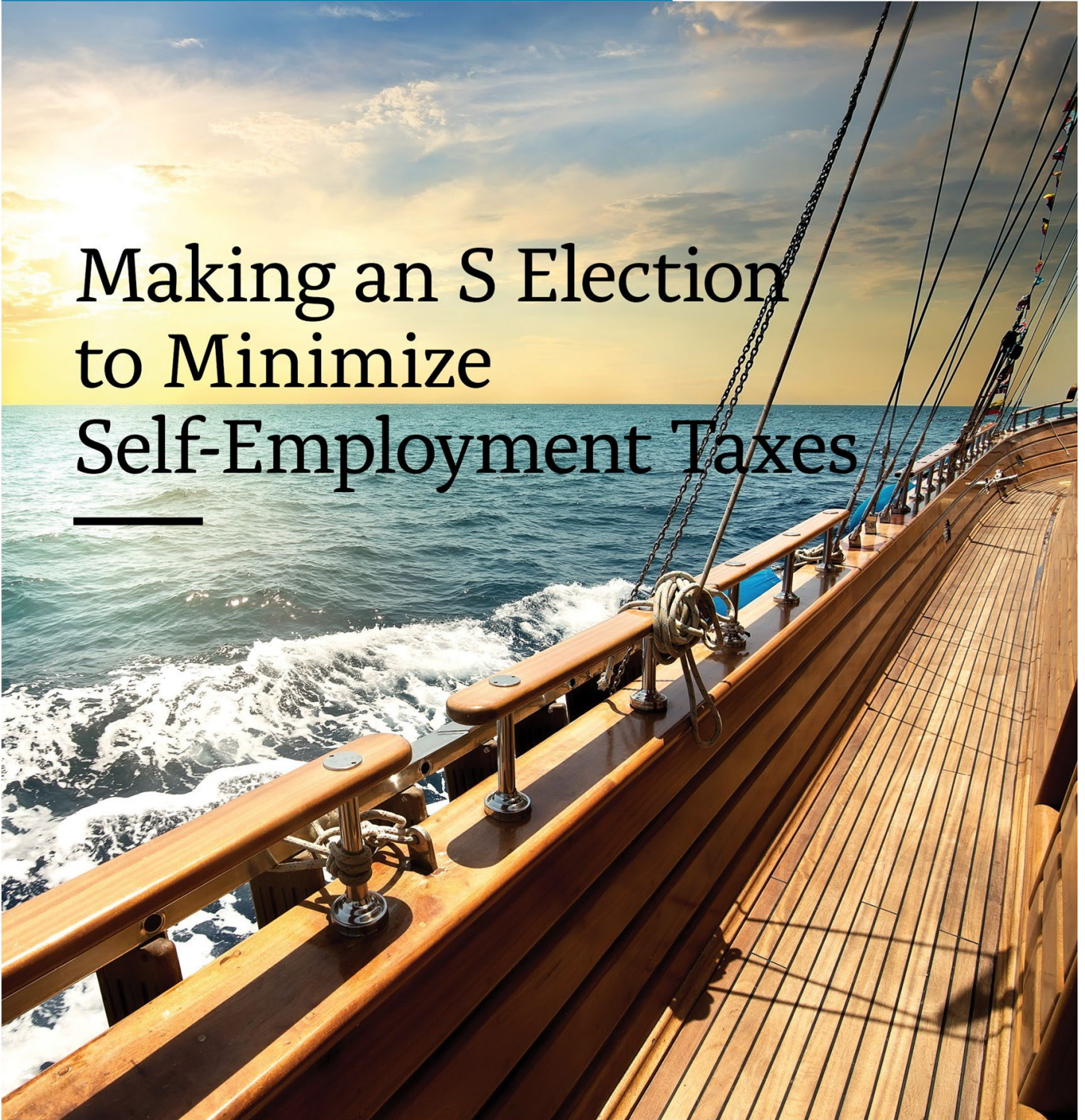




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# Making an S Election to Minimize Self-Employment Taxes

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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 net earnings up to \$184,500 for 2026, and Medicare tax (2.9%) on all net earnings, with no cap. Because these business owners are treated as both employer and employee, they bear the full 15.3% self-employment tax burden. However, one-half of the self-employment tax is deductible when calculating federal income tax.

In addition, higher-income individuals may be subject to an additional 0.9% Medicare surtax on wages or self-employment income exceeding \$200,000 (\$250,000 for married taxpayers filing jointly). Employers are required to withhold this surtax once an employee's wages exceed \$200,000, regardless of filing status.

## How S corporations are different

Owners of S corporations are subject to employment taxes only on the wages paid to them for services rendered, rather than on the entity's entire net income. This distinction may reduce overall employment tax exposure, provided the wages paid constitute reasonable compensation under IRS standards.

## Determining a reasonable salary

The IRS requires shareholder-employees of S corporations to receive reasonable compensation for services performed. Reasonable compensation is determined based on the facts and circumstances. Relevant factors 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 compensation is determined to be unreasonably low, the IRS may recharacterize distributions as wages and assess additional payroll taxes, penalties, and interest.

## Example: Potential tax savings with an S election

Assume a business generates \$500,000 of net income and reasonable compensation for the owner's services is \$100,000. Without an S election, the entire \$500,000 would generally be subject to self-employment tax. With an S election, only the \$100,000 salary is subject to employment taxes, while remaining profits may be distributed without additional employment tax, assuming IRS requirements are met.

### 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%):  $\$184,500 \times 12.4\% = \$22,878$
- Medicare tax (2.9%):  $\$500,000 \times 2.9\% = \$14,500$
- Additional Medicare tax (0.9%):  $\$250,000 \times 0.9\% = \$2,250$
- Total self-employment tax:  $\$22,878 + \$14,500 + \$2,250 = \$39,628$



## With an S election

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

- Social Security tax (12.4%):  $\$100,000 \times 12.4\% = \$12,400$
- Medicare tax (2.9%):  $\$100,000 \times 2.9\% = \$2,900$
- Additional Medicare tax (0.9%): Not applicable, as salary is below the \$250,000 threshold.
- Total employment tax:  $\$12,400 + \$2,900 = \$15,300$
- Estimated tax savings: \$24,328

This example above is for informational purposes only. Actual tax savings depend on individual facts, reasonable compensation determinations, and applicable tax law.

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As a result of H.R.1 of the 119th Congress (commonly known as the One Big Beautiful Bill Act), the estate, gift, and generation skipping tax exemptions amounts enacted under the Tax Cuts and Jobs Act of 2017 were made permanent. Effective January 1, 2026, the exemption amount will be \$15 million per person (\$30 million for a married couple), with annual adjustments for inflation. For asset transfers in excess of the applicable exemption amount and otherwise subject to such taxes, the highest applicable federal tax rate remains at 40%. In addition, under different rates, rules, and exemption amounts (if any), there may be state and local estate, inheritance, or gift taxes that apply in your circumstances. Please consult your own tax or legal advisor for advice pertaining to your specific situation. This tax-related discussion reflects an understanding of generally applicable rules and was prepared to assist in the promotion or marketing of the transactions or matters addressed. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. New York Life Insurance Company, its agents and employees may not give legal, tax or accounting advice. Individuals should consult their own professional advisors before implementing any planning strategies. These materials are prepared by The Nautilus Group®, a service of New York Life Insurance Company, and are made available to all Nautilus Group member agents and, as a courtesy, to select agents of New York Life Insurance Company. This material is provided for informational purposes only. The assumptions used in this material rely upon data provided by the client. Should the data have material omissions or be incomplete, the observations made herein may not be appropriate for the client's situation. This information should be used in conjunction with other factors and considerations specific to the client's situation. It should not serve as the sole basis for any planning actions which might be taken. SMRU 5016364 Exp. 12.31.2028