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Is an S Corporation Right for You?

The Self-Employment Tax Arbitrage — and the Costs That Quietly Erase It

Scenario: A profitable sole proprietor or single-member LLC owner has been told that electing S corporation status will "save on taxes," and wants a clear-eyed answer on whether the election actually produces a net benefit after every offsetting cost.

Executive Summary

The S corporation election is a self-employment tax arbitrage, not an income tax strategy. It does not change the amount of income tax you owe on your business profit by a single dollar. What it changes is the base subject to the 15.3% self-employment tax under §1401 — by recharacterizing a portion of profit as a distribution that escapes both Social Security and Medicare tax. The savings are real but bounded, and they are offset by payroll administration, a separate return, and, in California, a 1.5% entity-level tax that has no sole-proprietor equivalent. The election is worth making only when the distribution above a defensible salary is large enough that the Medicare-and-Social-Security saving outruns those fixed and recurring costs.

> **Key point**
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> The benefit is not a percentage of profit — it is the payroll-tax rate applied only to the *distribution* portion, and only to the extent that portion sits below the Social Security wage base or above it in the Medicare-only band. Modeling the whole profit as "saved at 15.3%" overstates the benefit, often by half.

The Mechanism, Precisely

A sole proprietor pays SE tax on 92.35% of net profit: 12.4% Social Security up to the annual wage base, then 2.9% Medicare on all of it, plus the 0.9% Additional Medicare Tax under §3101(b)(2) above the applicable threshold. A one-half deduction under §164(f) softens the income-tax side but not the cash cost. An S corporation instead splits profit into (1) W-2 wages, fully subject to FICA, and (2) a distribution that is *not* subject to FICA or SE tax because it is a return on the shareholder's equity, not compensation for services. The saving is the FICA/Medicare rate applied to the distribution — nothing more.

Where the Saving Actually Lands

Because Social Security tax stops at the wage base, the composition of the saving depends on where the salary falls relative to that ceiling:

Salary vs. Social Security wage base	Rate saved on the distribution	Why
Salary below the wage base	~15.3% on distribution (up to the base), then ~2.9%–3.8% above	Distribution avoids both the 12.4% and the Medicare components in the lower band
Salary at or above the wage base	~2.9%–3.8% on distribution	Social Security is already maxed by the salary; only Medicare remains to save
Owner also has outside W-2 wages near the base	Reduced Social Security benefit	Outside FICA wages consume the wage base first

The Costs That Offset the Arbitrage

- **California's 1.5% franchise tax (§23802).** California taxes S corporation net income at 1.5%, with an $800 annual minimum under §23153 — a direct give-back of part of the federal saving that most out-of-state analyses ignore.
- **Payroll infrastructure.** Real payroll with withholding, federal Forms 941/940, DE 9/DE 9C in California, W-2/W-3 issuance, and employer-side FICA and unemployment costs.
- **A separate return.** Form 1120-S plus Schedules K-1, and the CA Form 100S — added preparation cost and a second filing deadline (the 15th day of the third month).
- **Reasonable compensation exposure.** The salary must be defensible; an aggressive figure invites recharacterization, back FICA, and penalties.
- **Basis and formality discipline.** Stock and debt basis tracking under §1366(d), a dedicated account, and corporate formalities.

A Worked Illustration

Consider $200,000 of net profit and a defensible $110,000 salary, leaving a $90,000 distribution. The Social Security wage base is already largely consumed by the $110,000 salary, so the incremental saving on the distribution is primarily the Medicare band — roughly 2.9% to 3.8% of $90,000, or about $2,600–$3,400 — plus any Social Security saving to the extent the salary sits below the base. From that gross saving, subtract California's 1.5% on net income (roughly $2,700 on $180,000 of post-wage income, subject to the actual base), payroll-service fees, and the added 1120-S and 100S preparation cost. The residual benefit is real but modest at this profit level — and it inverts quickly if the salary must be set higher to be defensible.

> **Correction to a common assumption**
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> "The S corp saves 15.3% on everything above my salary" is wrong in most California cases. Once the salary approaches the Social Security wage base, only the 2.9%–3.8% Medicare band remains to be saved on the distribution — and California's 1.5% tax claws back part of even that.

Where the Election Reliably Fails

- Profit only modestly above a defensible salary — little distribution left to shelter.
- Capital-intensive or reinvestment-heavy businesses that retain rather than distribute earnings.
- Owners already at the Social Security wage base from outside W-2 work, collapsing the Social Security saving.
- Early-stage or volatile profit, where fixed compliance cost swamps an uncertain, fluctuating benefit.

Information to Gather for a Real Decision

- Projected net profit and its stability over the next several years.
- A defensible reasonable-compensation figure for your role, hours, and region.
- Any outside W-2 wages and their effect on the Social Security wage base.
- Whether the business is a specified service trade or business (this drives the QBI interaction — see the companion article).
- Retention needs versus distribution capacity.
- California nexus and the resulting 1.5% and $800-minimum exposure.

Next Step: Model the Net, Not the Gross

The right analysis is a side-by-side projection — sole proprietor versus S corporation — that nets the FICA/Medicare saving against California's 1.5%, the $800 minimum, payroll cost, and the second return, using a salary benchmarked to your profession. Only the net figure tells you whether the election earns its keep.

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