Bench

Our Most Asked Entrepreneur Tax Questions—

Answered by Experts

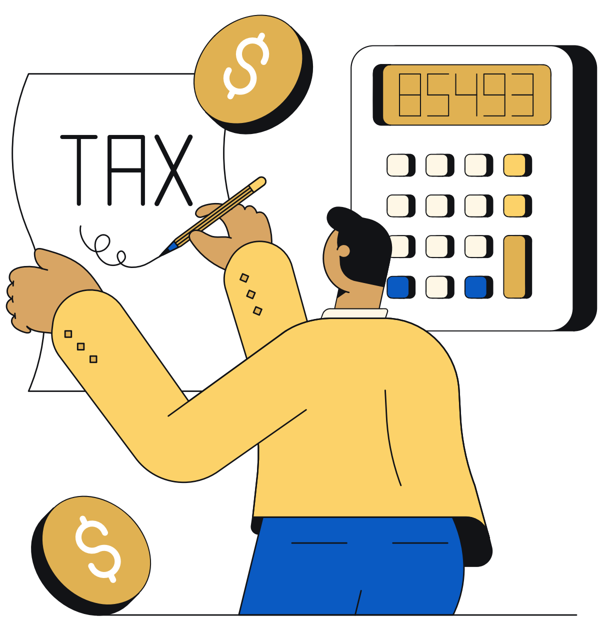
This was made in partnership with: GLOBAL ENTREPRENEURSHIP WEEK

Introduction

Is there anything more rewarding than being an entrepreneur? You get to build a business around something you love and learn a ton along the way. You meet new people and help them succeed. You delight customers and know you're making a positive impact in their lives.

When it comes to your company's finances and taxes, though, there's a lot to consider. Do you take a salary? How do estimated quarterly payments work? What about taking advantage of home deductions?

It can be overwhelming, but we've got your back here at Bench. Here are the top five questions entrepreneurs ask us—and the answers to keep you and your business running smoothly.



QUESTION 1

How do I pay myself?

No matter the industry, most entrepreneurs start their businesses because they have a passion for what they do. But eventually, that passion needs to translate into money, or the business won't survive.

A question we often get asked is how business owners should pay themselves. Is it okay to transfer money from the business account to your personal account? What about if you're a sole proprietor—should you pay yourself a wage?

As an entrepreneur, you have two options: an owner's draw or a salary.

1. With the **owner's draw** method, you'll adjust your compensation based on how well your business does. You'll pay yourself more when you have a quarter of significant growth. If you have a few lean months, you'll take less.

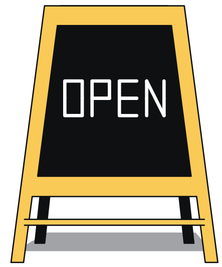
The owner's draw method offers flexibility but typically requires more paperwork. Owner's draws aren't considered personal income, so you need to calculate your business profits. That means reporting profits as income and paying quarterly estimated self-employment taxes, which can vary from quarter to quarter and add extra bookkeeping and accounting duties to your plate.

2. With the **salary** method, you'll receive the same amount of money each time you get paid. State and federal income taxes get automatically deducted, making it easier to track your finances. You'll have proof of consistent paycheck history for applying for a line of credit or mortgage.

One consideration is how much you should pay yourself as an entrepreneur. You have to satisfy the IRS's "reasonable salary" rules, which means your salary should be around standard industry pay. That requires additional research, but there's still some flexibility—you can adjust your salary or give yourself a bonus at the end of the year.

So, which option is best for you?

That depends on the type of business you’re running.



The owner’s draw method is likely best for a **sole proprietor, partnership,** or **LLC**.

When you need cash, transfer a suitable amount of funds from your business bank account to your personal one. As a sole proprietor or single-member LLC, you can pay yourself as much as you like so long as your business remains viable. But if you have a partnership or multi-member LLC, your income distribution will be split among partners. Your partnership agreement should outline the exact amount.

If you own an **S corporation** or **C corporation**, you must take a salary.

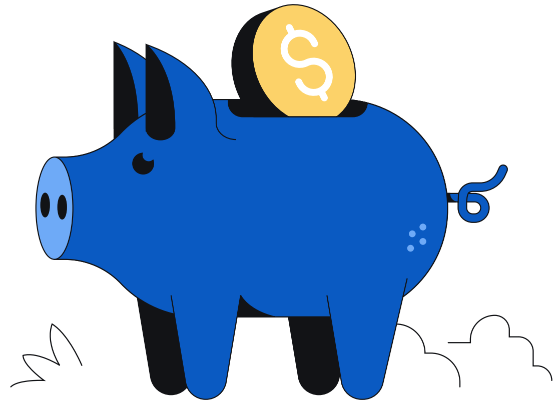
With an S corp, you can take non-taxable distributions from the company, though there are limitations around that process. C corporations can also get dividend distributions, though these distributions are taxable. The most important thing to know is you must take a reasonable salary. As the IRS puts it, business owners must receive “an amount that would ordinarily be paid for like services by like organizations in like circumstances.”

REMINDER

When tax time comes, you’ll file income tax forms and pay taxes on the business profits if you’re a sole proprietor, partner, or LLC.

QUESTION 2

What should I be saving for taxes?



Now that you know how to pay yourself, the next step is determining how much income to save for federal taxes and state taxes. If you're a newer entrepreneur, your business may not be profitable yet—do you need to pay taxes if that's the case?

The quick answer is no. When your business is losing more money than it's making, you don't have to pay taxes.

The first question is a bit more complicated, but you can still figure out what to set aside for taxes by following these three steps:

Step 1.
Get clarity on your tax obligations

As an entrepreneur, you'll pay self-employment tax for you and income tax for your business. You'll also pay employment (or payroll) tax if you have other employees.

Alas, federal taxes are only one component of the tax stew. Depending on the type of business you run, you must manage sales tax for items you sell, franchise tax for a sales tax nexus within a state, property tax for any real estate your business owns, and indirect excise taxes charged on goods you sell.

Take notice of the rules and avoid trouble later. Learn more about your state's tax authority and work with a CPA to determine what and how much you owe and when to pay it.

Step 2.
Use the 30% rule

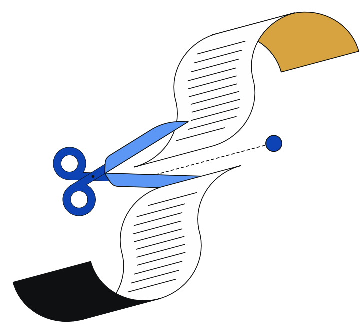
A good rule of thumb is to save 30% of your business income for federal taxes and an additional 10% for state taxes. If you're within that 30-40% range, you should be able to cover your quarterly estimated taxes.

Step 3.
Choose a saving method

You can set aside money for entrepreneur taxes any time you'd like, though that largely depends on the type of business and how long you've been in operation. Which of these best describes you?

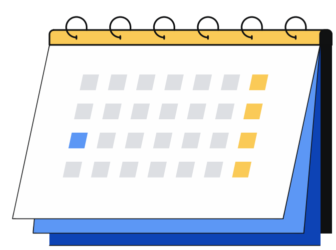
The per-payment method

If your business is new enough that you haven't filed a tax return, this is likely the correct method. With no history to draw from, it's harder to estimate both its income and what you owe, and your income may be inconsistent or steadily growing.



The per-payment method is simple: Whenever a client or customer pays you, put 30% of that payment into a business savings account. If you get paid on a per-project basis, this is relatively easy to do every time you get paid. If you sell items at a higher frequency, total up your income for a week or month, and then deduct 30% into your business savings account.

The monthly method



Your business has been running smoothly, and you're in your first year of profitability—congrats! Now it's time to update your tax savings method.

To start, calculate your average monthly income. Add up your total income for the year and then divide it by the number of months that have gone by since the beginning of the financial year. For instance, if you're in mid-April, you'll divide your total income by three to find your monthly income. If it's early in October, divide your total income by nine to find your monthly income.

Then, take 30% of your average monthly income. That's how much money you should set aside for taxes every month.

The monthly method is also ideal if you've earned much more (or much less) than the previous year since that data will be less helpful in estimating this year's taxes.

The yearly method

Once you've established a stable income that doesn't change much year over year, the yearly method is your best bet. And it involves less math, so if crunching numbers makes your head spin, you're in luck.

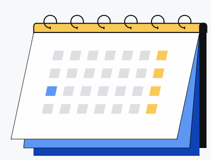
Look at your business's total income for last year and divide it by four. Then calculate 30% from that number. The resulting amount is what you need to save for quarterly estimated tax payments.

SUMMARY

METHOD 1

Per-payment

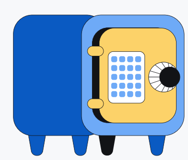
Whenever a client or customer pays you, put 30% of that payment into a business savings account.



METHOD 2

Monthly

Add up your total income for the year and then divide it by the number of months that have gone by since the beginning of the financial year. Then, take 30% of your average monthly income.



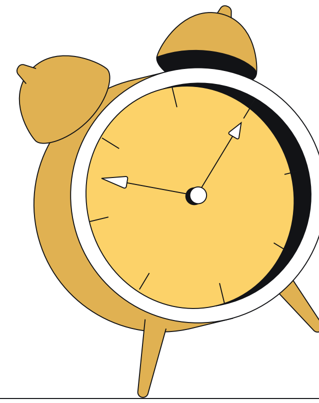
METHOD 3

Yearly

Look at your business's total income for last year and divide it by four. Then calculate 30% from that number.

QUESTION 3

How do quarterly estimated taxes work?



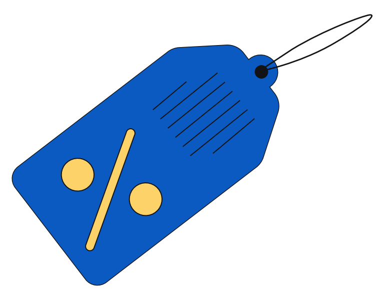
Picture this scenario: You start filing your return and enter your income from the past year. It turns out you owe much more than you thought you did. Suddenly, you've got a massive tax burden to pay. It's enough to make anyone break out into a cold sweat!

Estimated tax payments are designed to offload your tax liability from one large lump sum into four installments throughout the year. As the name suggests, you're gauging what you'll make for the year and paying the applicable taxes, including federal income tax and self-employment tax.

Do you file as a sole proprietor, partnership, S corporation shareholder, or self-employed individual? You'll typically need to pay estimated quarterly taxes if you owe $1,000 or more in taxes. File as a corporation and that threshold drops to $500 or more in tax for the current year. You're likely required to make quarterly estimated payments, though there are a few rare exceptions.

So, how to calculate your estimated taxes? You can do it in four easy steps:

Step 1.
Estimate your taxable income



Start by assessing your estimated total income. You'll then subtract above-the-line deductions such as certain business expenses, moving expenses, and contributions to health savings accounts. The resulting number is your adjusted gross income.

You'll probably take the standard deduction—$12,950 for single taxpayers in 2022—and can deduct 50% of your self-employment tax.

After you've made those deductions, you'll have your total estimated taxable income.

Step 2.
Calculate your income tax

Take your adjusted gross income (estimated income minus above-the-line deductions) and multiply it by your income tax rate. Use the latest tax numbers to stay current on what each bracket owes.

Step 3.
Calculate your self-employment tax

You'll also owe self-employment tax if you earn more than $400 in a year. This step involves some tricky math, so it can be helpful to consult with a CPA.

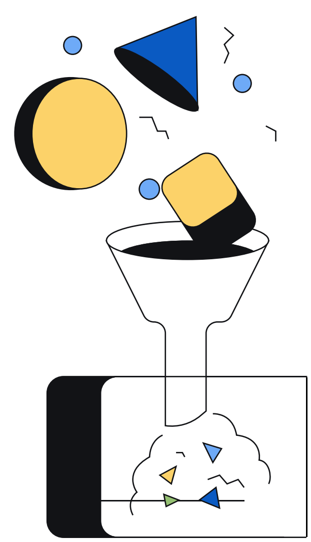
Start with your estimated total income and multiply it by 92.35%, which is your self-employment taxable income. Next, multiply the self-employment taxable income number by 15.3%, a combination of Social Security tax and Medicare.

The resulting total will be your estimated self-employment taxes.

Step 4.
Add up the total and divide by four

By this point, you'll have estimates for your income tax and self-employment taxes. Add those two numbers together and then divide by four to find your quarterly tax payment.

The good news is that your estimated payments don't need to be completely accurate. The IRS says you can't be penalized for underpaying if this year's payment is 100% of the previous year's quarterly payments. This rule changes if your income is $150,000 or more—in that case, you'll need to pay 110% of last year's income or 90% of the current year's income to qualify for this "safe harbor" rule.



Whether you underpay or overpay, you'll need to make up the difference come tax time. In the case of the former, you'll pay the remainder when filing your taxes. Should you overpay, you'll receive that money in the form of a tax refund. And while it's tempting to splurge on a shiny new item, you can save yourself future headaches by putting that refund towards next year's return or quarterly estimated tax payments.

SAVE THIS

Estimated quarterly tax payments are due on the 15th of April, June, September, and January.

1. Mid-April
2. Mid-June
3. Mid-September
4. Mid-January

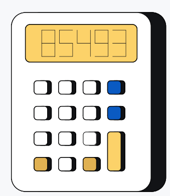
If the 15th of one of these months falls on a weekend or legal holiday, you'll owe your payments on the next business day.

You have a few different options for paying:

- Mail form 1040-ES and a check or money order to the nearest IRS office.
- Use your credit card online or via phone on the IRS payments gateway.
- If you're a corporation, file quarterly payments through the Electronic Federal Tax Payment System.

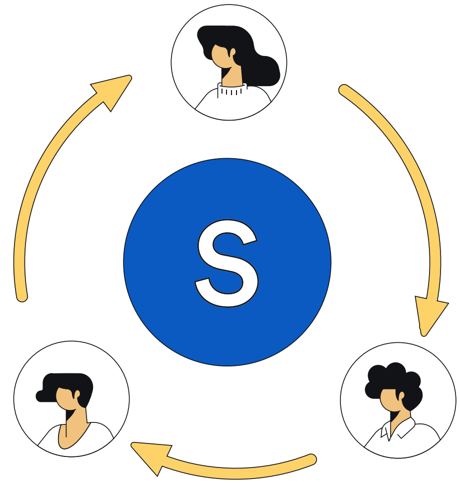
PRO TIP

Not sure what you owe each quarter?
Get help with our free estimated tax calculator.



QUESTION 4

Should I consider switching to S corp?



As your business evolves, you might start considering different options to protect yourself or ease your tax burdens. If you're already incorporated, one avenue you could approach is an S corporation.

An S corporation, or Subchapter S corporation, is a special tax status that declares your business as a separate entity from your personal finances. S corporations don't pay federal corporate taxes because their corporate income, credits, and deductions go through shareholders. This designation can help protect your personal assets and reduce your federal tax rate.

Here are some of the pros and cons of filing taxes as an S corp:

Pro: You avoid double taxation

Typically, corporations are taxed at the corporate and individual levels. You pay taxes when the corporation earns income and again when distributing dividends to owners. By filing as an S corporation, you pay taxes as a pass-through entity, as a limited liability company (LLC) or sole proprietorship would. So, instead of paying federal income tax, you pay employment tax (which includes Social Security and Medicare) on employee wages. The remaining income goes to shareholders as "distributions," which avoid a self-employment tax.

Con: You must adhere to "reasonable salary requirements"

The IRS requires S corp owners to take a "reasonable salary" and offers a list of factors they consider in that assessment.

To determine reasonable compensation, factor in your duties and responsibilities, the effort devoted to the business, the time for training and experience, dividend history, payments to non-shareholder employees, and what other people in similar industries earn. You'll need to ensure your business is making enough money to pay yourself a reasonable salary while still having a remainder for a dividend payment.

Pro: You have simpler accounting rules

Do you own an S corporation without inventory? Then you can use the less complex cash method of accounting: income is taxable, and paid expenses are deductible.

Con: You may have state-specific taxes

Each state has its own rules around S corp designations. Some may not recognize the S corp status for state taxes or treat the business like a C corp. You might also be required to pay franchise or excise taxes only applicable to S corps. Know your state requirements before applying for an S corp.

Pro: You can transfer ownership easily

If you or a partner need to stop running the business for whatever reason, it's easy to exit an S corp structure. You'd simply sell your shares to the remaining owners. In the event of a sale, the shares would easily transfer to the new owners.

Con: S corporation status is fluid

You might meet all the requirements of S corporation status today, but what if something changes in the future? The IRS is unforgiving and will immediately change your status, so you get taxed as a C corporation.

Filing for S corp status could be a smart idea if you're a mature business looking to save on your tax burden by distributing profits to owners. Additionally, if you intend on paying yourself a reasonable salary and don't anticipate having more than 100 shareholders, S corp status may be a good fit.

Only some companies can file for S corp status, though. Your business needs to meet these conditions to apply with the IRS:

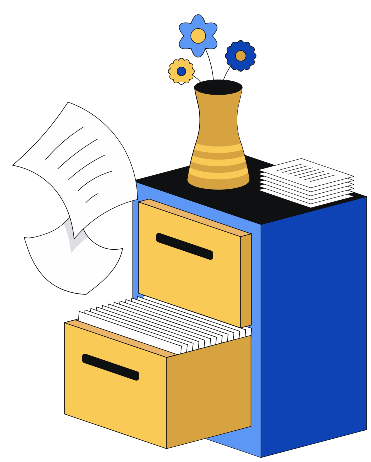
- Be a domestic corporation
- Have only allowable shareholders, including individuals, certain trusts, and estates
- Have no more than 100 shareholders
- Issue only one class of stock
- Not be an ineligible corporation, such as certain financial institutions, insurance companies, and domestic international sales corporations

If you fit into all these categories, you can file for S corp status any time within the first two months and 15 days of the taxable year. But if you're currently operating as a C corp, you can file for the S corp election any time during the preceding tax year, giving you more flexibility. For example, if you've filed your 2022 taxes but want to file as an S corp next year, you have from now until March 15, 2023.

To file for S corp status, choose a name if you don't already have one. Establish a board of directors to represent the shareholders. Next, file your corporate bylaws with your local Secretary of State office. These bylaws should include meeting frequency, voting rights, and selling stock. Finally, file IRS Form 2553 before the due date. You'll need the names, addresses, Social Security numbers, percentage of ownership, and signatures of all shareholders or members.

Did you start as an LLC and are interested in changing to an S corp in the future? You can operate with both structures in place, which is often advantageous. Your business remains an LLC for administrative purposes, typically decreasing bookkeeping requirements. But you also get the benefits of an S corp, with pass-through income and no worrying about double taxation. The S corp status may also give you tax relief for payroll taxes, assuming your LLC business is highly active.

An S corp can be advantageous in the right scenarios, though it's not the only way you can save on your taxes as an entrepreneur.



QUESTION 5

How do I take advantage of home office deductions?

While the uptick in remote work over the past few years has been good news for convenience and cutting down on commutes, there's a significant financial benefit, too. If your business operates from home, you can take advantage of the home office deduction.

To qualify for a home office deduction, you must be self-employed, a sole proprietor, a partner in a partnership, or a member of an LLC that hasn't elected to be taxed as a corporation. You must also follow the criteria of regular and exclusive use and principal place of business. Here's a more in-depth look at each:

Regular and exclusive use

The space where you conduct business should be a distinct area of your home. That could look like a spare room you turn into an office or a corner space where you add a desk. The key is a clear, identifiable boundary—working from the dining room table where you eat meals or the couch where you watch TV won't fly.

You must also consistently use your home office. If you run a business from home, either full- or part-time, but regularly work Monday to Friday—or even fewer days, but on a consistent schedule—you'll likely qualify for home office deductions.

Principal place of business

Your home office should be where the majority of your work gets done. While you can work at or meet clients in an office or coffee shop, you must also use your home "substantially and regularly to conduct business."

Though your home office is likely part of your home, you can deduct expenses for a separate, free-standing structure. For example, if you have a studio, garage, shed, or barn that you use exclusively and regularly for your business, it qualifies as a deduction, even if it's not your principal place of business.

These same criteria apply if you're a renter—you'll use the home office regular method to determine what you can deduct from your monthly rent.

We'll get to that method in a minute, but first, what can you deduct if you work out of your house?

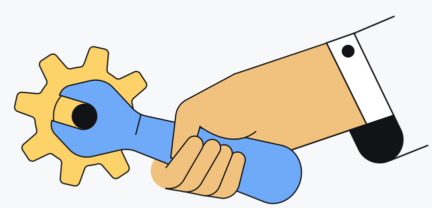
The IRS looks at two different types of expenses.

1 Direct expenses

They are 100% deductible and are expenses you incur only in the part of the home where you conduct business. These could be purchases of an upgraded computer, a work phone, office repairs, or a new desk.

2 Indirect expenses

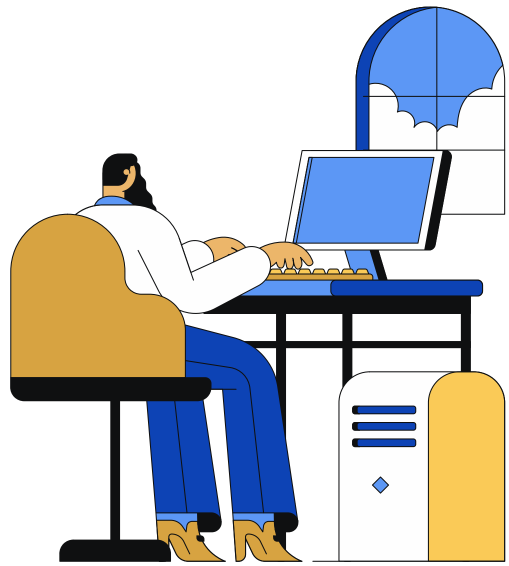
They are for the maintenance of your entire home. These types of expenses include mortgage interest or rent payments, utilities, insurance, real estate taxes, and security.



The amount you deduct for indirect expenses depends on the percentage of your home you use for business. You can determine that percentage utilizing the home office regular method or the simplified method.

Regular method

The home office regular method involves taking the square footage of your home that you use for business and dividing it by your home's entire square footage. That number is the percentage of your home that you use for business. For example, if your home is 2,000 square feet and you use 400 of it for business, you can deduct 20% of your indirect home expenses from your taxes.



Simplified method

An easier-to-calculate option is the home office simplified method. You'll create a standardized deduction of $5 per square foot of your home that you use for business activities, up to a maximum of 300 square feet (or $1,500). This method is less complicated, though if your home office deductions are likely to surpass $1,500, it might not be the most valuable.

Once you've applied your home deductions, you can put the savings toward other parts of your business.