How S-Corp Owners Should Pay Themselves

A Practical Guide to Salary and Distributions

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You Wear Two Hats—Owner & Employee

As an S-Corp shareholder actively working in your business, you're both an owner and an employee. That means you get paid in two ways:

- A **salary (W-2 income)** for the work you do.
- **Distributions (profit payouts)** because you own the business.

Understanding how to balance the two is key to maximizing tax efficiency and staying compliant with IRS rules.

Why Your Compensation Matters

As an S-Corp owner, how you pay yourself affects your taxes, cash flow, and compliance. By default, a single-member LLC is taxed as a sole proprietorship, and a multi-member LLC as a partnership—both subject to income and self-employment taxes on all net income. In contrast, S-Corp owners must take a reasonable salary (subject to payroll taxes) but can distribute remaining profits tax-efficiently, reducing self-employment tax exposure.

Key Components of S-Corp Owner Compensation

1. Reasonable Salary (W-2 Income)
   - The IRS requires S-Corp owners actively working in the business to take a reasonable salary before taking distributions.
   - What constitutes a 'reasonable salary' can be interpreted in different ways, and we always approach it strategically—ensuring you take enough in salary to satisfy IRS requirements while minimizing the payroll tax burden where possible.
   - Payroll tax impact: Subject to Social Security and Medicare (FICA) taxes, plus federal and state withholding.
2. Distributions (Profit Payouts)
   - Distributions are paid from company profits after salary is accounted for.
   - Tax advantage: Not subject to self-employment tax (FICA), only personal income tax.
   - Balance required: Over-reliance on distributions while underpaying salary could trigger IRS scrutiny.

What This Means for You

1. No need to follow a rigid payroll schedule.
   - If you are a solo S-Corp owner, you don't need to issue yourself a biweekly paycheck.
   - Instead, funds can be transferred from business to personal accounts as needed.
   - These transfers are considered distributions, not salary.
2. Salary is a tax classification, not a rigid paycheck system.
   - Your CPA will work with you to determine how much of your total income should be classified as salary versus distributions.
   - This is typically done quarterly or annually based on financial performance and tax strategy.
3. Retirement planning can influence salary structure.
   - A higher salary allows for larger contributions to tax-advantaged retirement plans like a 401(k) or SEP IRA.

Tax Savings Comparison

S-Corp Strategy vs. W-2 All Salary

Scenario	Total Compensation	Payroll Taxes	Overall Tax Burden
S-Corp (Salary + Distributions)	$190,000 ($70K Salary, $120K Distribution)	~$10,710	Lower due to tax savings
W-2 All Salary	$190,000 (All Salary)	~$29,070	Higher due to increased payroll taxes

Optimizing S-Corp Compensation, Retirement, and Tax Benefits

Expenses and Compensation

Category	Amount	Notes
Gross Revenue	$300,000	Total income generated by the business
Business Expenses	$110,000	Includes rent, marketing, supplies, and employer-paid retirement contributions
Net Profit	$190,000	Revenue minus business expenses
Reasonable Salary (W-2)	**$70,000**	**Subject to federal income and payroll taxes**
Distributions	**$120,000**	**Subject to income tax, but not payroll taxes**
Payroll Taxes (Employer & Employee)	~$10,710	15.3% on $70,000 salary
Retirement Contributions (Employer)	Included in Expenses	Employer contributions to SEP IRA or 401(k)
Retirement Contributions (Employee)	Deducted from Salary	Owner's own contributions from W-2 earnings
Total Payroll & Retirement Taxes	Varies	Combination of payroll taxes and contributions
Tax Savings (S-Corp vs. W-2 Only)	~$18,360	Payroll tax savings by structuring income strategically

How Retirement Contributions Affect Compensation Structure

If an S-Corp owner wants to prioritize higher retirement contributions, they may opt to increase their W-2 salary to allow for larger tax-deferred employee contributions.

Key Considerations:

1. A balanced approach keeps salary lower ($70,000) and distributions higher ($80,000), minimizing payroll taxes while maintaining compliance.
2. A retirement-focused approach increases salary ($100,000), reducing distributions but allowing for larger employer and employee contributions to retirement plans.
3. Higher salary means more payroll taxes but greater tax-deferred retirement savings potential.