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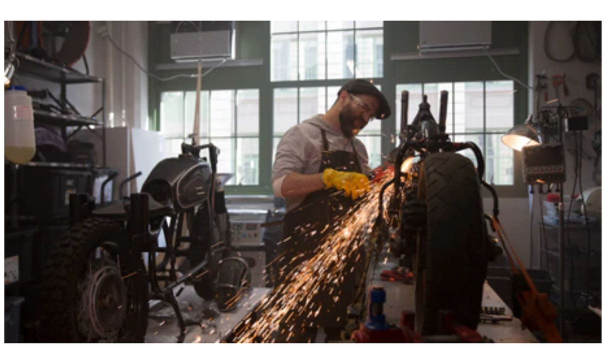
Salary or Draw: How to Pay Yourself as a Business Owner



By Ken Boyd June 24, 2013

If you're a sole proprietor, a member of a limited liability company (LLC), or a partner in a partnership, you need to think carefully about how you take money out your business entity.

Use these tips to determine how you should pay yourself as a business owner.

How to Pay Yourself From Your Business

Some business owners pay themselves a salary, while others take an owner's draw to compensate themselves. You may decide to use one of these methods, or a combination of both.

What is an Owner's Draw?

An owner's draw (or simply a draw) refers to an owner taking funds out of the business for personal use. Many small business owners compensate themselves using a draw, rather than paying themselves a salary.

The business owner may withdraw profits generated by the business, or take out funds that the owner previously contributed to operate the company. An owner's draw may also be a combination of profits and capital contributed.

A draw of company profits is taxable as income on the owner's personal tax return, and owners must pay estimated tax payments and self-employment taxes on draws.

Should I Pay Myself a Salary?

You may decide to pay yourself a salary, rather than take a draw. One advantage of taking a salary is that tax withholdings and benefit payments come out of your gross pay automatically.

How Much Should I Pay Myself As a Business Owner?

Business owners pay income taxes and self-employment taxes using either a salary or a draw. Your decision about compensation should be based on how much money your business needs to operate moving forward, and if you're willing to do more personal tax planning by using the draw method.

Business Taxation

Before you make the salary vs. draw decision, you need to form your business. There are many ways you can structure your company, and the best way to understand the differences is to consider C corporations (C Corps) vs. all other business structures:

- **C Corporation:** C Corps are subject to double taxation. The C Corp files a tax return and pays taxes on net income (profit). The owners can retain the after-tax earnings for use in the business, or pay shareholders a cash dividend. If a dividend is paid, the dividend income is added to other sources of income on the shareholder's personal tax return.

- **Pass-through entities**: Most other business structures pass the company profits and losses directly to the owners. Sole proprietorships, partnerships, S Corporations (S Corps), and several other businesses are referred to as pass-through entities. Assume, for example, that your share of a partnership's profit is $10,000. The partnership files a tax return, and issues you a Schedule K-1, which reports the $10,000 in income, and the $10,000 is added to your other income sources on your personal tax return. The partnership tax return documents the partners, the percentages of ownership, and the partnership's profit- but no taxes are calculated on the partnership tax return.

There are some exceptions, but generally a business faces double taxation as a C Corp, or the company is a pass-through entity.

What is Owner's Equity?

Once your form a business, you'll contribute cash, equipment, or other assets into the business. When you contribute assets, you are given equity (ownership) in the entity, and you may also take money out of the business each year. To make the salary vs. draw decision, you need to understand the concept of owner's equity.

Accountants define equity is defined as the true value of a business, and equity is based on the balance sheet formula:

Assets are resources used in the business, such as cash, equipment and inventory. Liabilities, on the other hand, are obligations owed by the business. Accounts payable, representing bills you must pay every month, is a liability account, along with any long-term debt owed by the business.

> **Assets – liabilities = equity**

If a company sells all of its assets for cash, and then uses the cash to pay all liabilities, any cash remaining is the firm's equity.

Each owner can calculate his or her equity balance, and the owner's equity balance has an impact on the salary vs. draw decision.

How to Pay Yourself as a Sole Proprietor

A sole proprietor's equity balance is increased by capital contributions and business profits, and is reduced by owner draws and business losses.
Assume, for example, that Patty owns Riverside Catering as a sole proprietor, and that she contributed $50,000 when the business was formed at the beginning of the year. Riverside Catering posts this entry to record Patty's capital contribution:

	Debit	Credit
Cash	$50,000	
Owner's equity- Patty		$50,000

A normal balance for an equity account is a credit balance, so Patty's owner equity account has a beginning balance of $50,000.During the year, Riverside Catering generates $30,000 in profits. Since Patty is the only owner, her owner's equity account increases by $30,000 to $80,000. Also, the $30,000 profit is posted as income on Patty's personal tax return.
At the end of the year, Patty can choose to take an owner's draw, which refers to taking money out of the business. Patty could take some or all of her $80,000 owner's equity balance out of the business, and the draw would reduce her equity balance.

Patty pays taxes on the $30,000 profit, regardless of how much of a draw she takes out of the business.

If Patty decides to take a salary of $25,000 a year, the salary increases the business expenses and reduces profit. For example, a $25,000 salary would lower the profit from $30,000 to $5,000. Riverside Catering would issue a W-2, and Patty would pay taxes on the $25,000 salary, as well as pay taxes on the $5,000 in business profit.

How to Pay Yourself in a Partnership

A partner's equity balance is increased by capital contributions and business profits, and reduced by partner (owner) draws and business losses.
Patty is also a partner in Alpine Wines, a wine and liquor distributor. Patty and Susie each own 50% of Alpine Wines, and their partnership agreement dictates that partnership profits are shared equally. Patty contributes $70,000 into the partnership when the business is formed, and Alpine Wines posts this journal entry:

	Debit	Credit
Cash	$70,000	
Partner equity- Patty		$70,000

The partnership generates a $60,000 profit in year one, and $30,000 of the profit is reported to Patty on Schedule K-1. Patty includes the K-1 on her personal tax return, and pays income taxes on the $30,000 share of partnership profits.Assume that Patty decides to take a draw of $15,000 at the end of the year. Here is her partner equity balance after these transactions:
$70,000 contributions + $30,000 share of profits – $15,000 owner draws = $85,000 partner equity balance

A partner cannot be paid a salary, but a partner may be paid a guaranteed payment for services rendered to the partnership. Like a salary, a guaranteed payment is reported to the partner, and the partner pays income tax on the payment. The partnership's profit is lowered by the dollar amount of any guaranteed payments.

How to Pay Yourself from a Limited Liability Company (LLC)

You form an LLC according the state law, and the rules for LLC's differ slightly by state. An LLC may be taxed as a sole proprietorship, or as a partnership, so the rules explained above will apply to how to pay yourself as an LLC.

Corporations

A shareholder in a corporation may receive a dividend, which is a distribution of company profits. A dividend is taxed on the shareholder's personal tax return. The corporation, however, may choose to retain some or all of the earnings and not pay a dividend.

Social Security and Medicare Taxes

Social Security and Medicare taxes (FICA taxes) are collected from both salaries and draws.

Sole proprietors, members of LLCs, and partners in a partnership each pay self-employment taxes on draws and other distributions. The self-employment tax collects Social Security and Medicare contributions from these business owners. If, instead, a salary is paid, the owner receives a W-2 and pays Social Security and Medicare taxes through wage withholdings.

Finally, S Corp shareholders do not pay self-employment taxes on distributions to owners, but each owner who works as an employee must be paid a "reasonable salary" before profits are paid. The IRS has guidelines that define what a reasonable salary is, based on work experience and job responsibilities.

Risks of Taking Large Draws

A business owner may pay taxes on his or her share of company earnings, then take a draw that is larger than the current year's earnings share. In fact, an owner can take a draw of all contributions and earnings from prior years. If the owner draw is too large, however, the business may not have sufficient capital to operate going forward.

Say, for example, that Patty has accumulated a $120,000 owner equity balance in Riverside Catering. Her equity balance includes her original $50,000 contribution, and five years of accumulated earnings that were left in the business. If Patty takes a $100,000 owner draw, the catering company may not have sufficient capital to pay for salaries and food costs.

Avoiding Tax Confusion

You may pay yourself a salary, and take an additional payment as a draw, based on profit for the year. Paying a salary and taking an owner's draw requires the business owner to pay taxes using two different methods, and you need to plan carefully to pay your tax liability on time and avoid penalties.

The Right Method for You: Salary or Draw

Most businesses are set up as a sole proprietor, LLC, or a partnership, which means that you may have the opportunity to take a draw or a salary (or both). Base your decision on these factors:

- **Business funding**: You need to leave enough capital in the business to operate, so consider that before you take a draw.

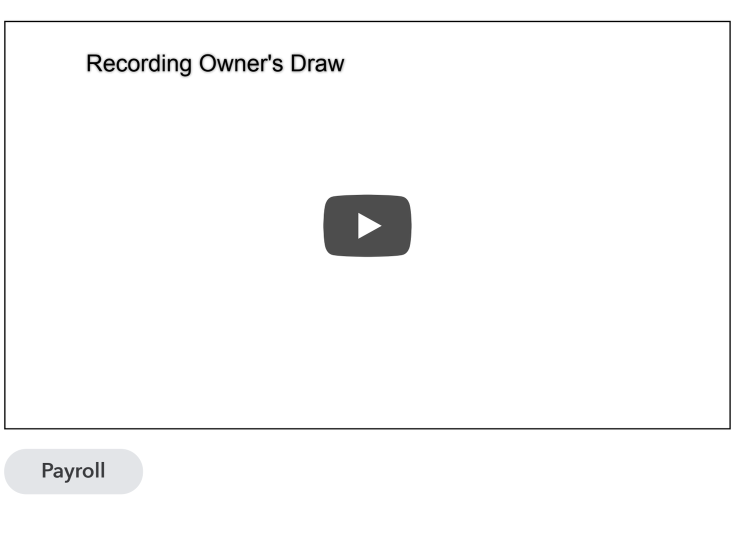
- **Tax liability:** A business owner needs to be very clear about the tax liability incurred, whether the distribution is a salary or a draw. Work with a CPA to plan for your tax liability, and any required estimated payments.

- **Each method generates a tax bill**: You'll pay Social Security, Medicare, and income taxes through each type of business entity. Your decision about a salary or owner's draw should be based on the capital your business needs, and your ability to perform accurate tax planning.

This decision regarding a salary or a draw impacts your business and your personal tax liability.

How to Pay Yourself in Quickbooks

Finally, paying yourself an owner's draw in Quickbooks is easy. Watch the short video below to get a step-by-step walkthrough.



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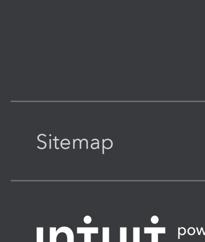

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