Single Member S Corps and Payroll: What LLC Owners Should Think About

If you are the sole owner of an LLC, you may wonder how electing S corporation status will affect your business taxation. Many LLC entities have made or are considering making an S Corporation election. This election can be made when the LLC is formed or any time after formation. You can make this election by filing form 2553 with a start date up to 2 ½ months before the election is filed.

After electing S Corp status, does the single-member LLC owner become an employee?

Prior to electing S Corp status, the business owner would have reported all the business profit on their Form 1040, Schedule C. On the 040, the profit of the business would be taxed for income tax purposes as well as for self-employment tax [15.3%]. After electing S Corp status, the single-member LLC owner puts themselves on payroll and they receive a paycheck for the services they provide to the LLC. This may be advantageous for the business owner as only the business owner's payroll is subject to payroll taxes.

For example, if an LLC has $90,000 of profit, the entire profit is subject to income tax and self-employment tax. If the LLC has elected to be taxes as an S Corporation and $60,000 is determined to be a reasonable salary for the owner. The remaining profit ($30,000) is only taxed for income tax purposes.

Is the owner's payroll handled differently than for other employees?

Income taxes, FICA taxes (Social Security and Medicare taxes), Oregon transit tax and other applicable deductions are withheld from the owner's paycheck - just like any other employee of the company. Half of the FICA tax is withheld from the employee's wages and the company pays the other half. Previously the LLC was paying 100% of the FICA taxes.

What happens if an owner leaves profits in the LLC?

The owner is taxed on the annual profit of the LLC whether it is distributed or left in the LLC. In the example above, the owner is taxed on the $60,000 of wages and the $30,000 remaining profit. If the owner leaves all or part of the $30,000 profit in the business, they can later take tax-free distributions (subject to basis limitations).

How much should an owner pay themselves as an employee?

The business owner must ensure that they are paid a reasonable amount. What is reasonable is not a bright line. It is usually defined as the amount that other businesses would pay employees in similar positions as to what the LLC owner is providing to the business. There are websites such as salary.com that can provide guidance as to what is reasonable. Often industry organizations track compensation. Also, the reasonableness of the salary is based on your location. We suggest that you document how you arrive at the payroll you are receiving. The payroll should be adjusted on an annual basis to reflect the current economic environment.

Is there such a thing as too low or too high payroll?

With an S Corp structure, the IRS is not concerned with payroll being too high. However, the IRS is concerned with situations where business owners pay themselves low wages and simultaneously take large distributions. Because the distributions are not subject to payroll taxes, abuses occur. This is an IRS hot audit issue, so you will want to make sure your owner's compensation is not too low.

Here are some factors the IRS uses for determining reasonable compensation:

- Job Duties and Responsibilities
- Education and work experience of the person
- Time and effort devoted to business.
- Payments to non-owner employees
- Compensation paid to employees by other businesses for similar services.

Are there any situations when a business owner does not become a paid employee of their S Corp?

Yes, an owner does not need to be placed on the payroll if they only have an exclusive financial interest in the business and have hired other employees to manage the day-to-day operations and management of the business. In such a situation, the owner may be paid in profit distributions alone.

Like other decisions that affect how you are taxed and generate income from your business, changing the default tax status from an LLC to an S Corporation requires careful consideration. Hendrick & Kellison LLC can help you analyze whether an S Corporation election makes sense for you.