How to Pay Yourself

Sole Proprietor & Single Member LLC

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The Truth About Why Draws and Distributions Are Non-Taxable

When you are a pass-through entity, the profits of a business are taxable to the individual owners based on their unique tax situation. Often these owners will take cash out of the business as compensation in the form of periodic draws or distributions. Assuming you have a profitable business, these draws and distributions are simply a mechanism that allows owners to take out excess cash from the business. Therefore, owner draws and distributions do not have any income tax consequences to the individual. This concept often creates a level of confusion for founders not versed in a few basic principles of accounting. To understand the concept of an owner draw or distribution, we must review a few basic accounting principles.

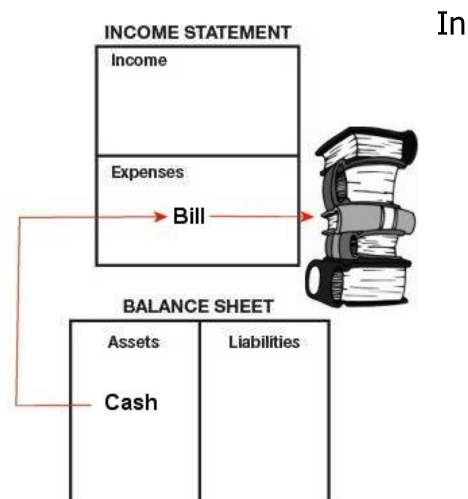
There are 2 primary financial statements for every business. One statement is the Profit & Loss (P&L), sometimes called an income statement. The other statement is a balance sheet. The P&L is a document to record the profit or loss of a business for income taxes while the balance sheet is a document to record the equity in the business.

In accounting, a company has what are known as a chart of accounts. Some chart of account line items are classified as income accounts and some others as expense accounts. Income accounts and expense accounts are reported on the company's P&L. If you take income and subtract expenses, you are left with net profit, which is also part of the company's P&L.

P&L (Revenue – Expenses = Net Profit)

Another set of chart of accounts are classified as asset accounts and others as liability accounts. Assets accounts and liability accounts are reported on the company's balance sheet. If you take your assets and subtract your liabilities, you are left with equity, which is also part of the company's balance sheet.

Balance Sheet (Assets – Liabilities = Equity)



In accounting, for every transaction there is a debit and credit taking place between two charts of accounts.

When you write a company-check to pay a bill, such as when you buy some business books, you take money from a chart of account line item called cash (Cash is an asset and lives on your balance sheet) to pay a bill that lives on

your P&L. Bills are allocated to their appropriate expense chart of account line item.

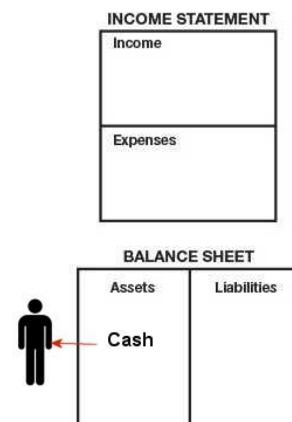
Since you reduced cash on your asset chart of account, equity is also reduced to keep things in balance. Equity has to be reduced because it is the result of your assets minus your liabilities. Additionally, since the cash was used to pay an expense your profit is also reduced. Profits must be reduced because it is the result of income minus expenses.

When you take an owner draw or a distribution, you reduce cash (an asset chart of account) and you reduce a special equity line item account. Similarly, if you inject cash into a business, you increase cash and increase a special equity line item account.

The results of an owner draw or distribution (money leaving the business) or a cash infusion (money entering the business) are that both sides of the transaction are restricted to the chart of accounts that live only on the balance sheet. Since we know that the P&L is used to compute a company's tax liability and owner draws, and distributions or infusions do not touch the P&L, there are no tax consequences for doing either an owner draw, distribution, or a cash infusion in the normal course of business. An exception is when you close out the business and have a negative equity situation but that is the subject better left to your CPA.

Therefore, as a lifestyle or micro business, you only need to make sure there is enough cash in the business checking account to cover all non-discretionary expenses. All other money is at your discretion to either take out as a periodic owner draw or distribution on profits or to leave in your business as excess cash or use to pay discretionary expenses in the hopes of growing your business.

How to Get Paid as an Owner of a Pass-Through Entity



In my practice as a small business coach and mentor, a question I often get asked is how do I pay myself as an owner? What makes this question so hard to answers is that it all depends upon the type of entity you are and how many owners there are.

Some entities have only one owner while others may have several owners, which changes the way income tax is reported to the IRS.

In a pass-through entity, sometimes income is considered earned income (sometimes called ordinary income or active income) while other times it is considered passive income, which changes the way income taxes are computed.

Your role in the business as a decision maker (manager/officer) or a simple investor (member/shareholder) will define how your income taxes are calculated.

Income tax treatment, therefore, will dictate the way you will get paid as an owner.

Later in this paper we will discuss in greater detail how you get paid as an owner of a sole proprietor or as the owner of a single member LLC. However before getting to the specifics, I want to lay the groundwork and define a few terms that should help demystify how entities pay the owners of the business.

What Is a Pass-Through Entity?

Most small business founders choose one of the many entity types known as pass-through entities. By definition, a pass-through entity is not subject to income taxes at the entity level. Rather, the owners are taxed individually based on their ownership share of the business. The only entity not considered a pass-through is the C-Corp and we will not discuss C-Corps in this paper.

What Are Your Pass-Through Entity Type Options?

Technically, when it comes to an entity selection, a sole proprietor is technically not a specific entity designation you would make with the Secretary of State. A sole proprietor is simply when one person decides to operate a business. As a sole proprietor you do not file for a specific entity status with the Secretary of State. Since the business is not separate from the individual, there is no type of liability protection. We use the sole proprietor designation only to distinguish them from other entity types since they are treated differently by the IRS.

With respect to a single member LLC it too is not a specific entity designation. It is simply an LLC with only one member and therefore is treated differently than an LLC that has more than one member. We use the single member designation only to distinguish it from a traditional LLC with several members.

How to Report the Profit and Loss of Business

A company should have a Profit & Loss (P&L), or income statement, which is an internally prepared tax document that is used by the business to compute the business owner(s) annual tax liability.

When the business is a sole proprietor or a single member LLC, the figures from the P&L are used to populate the owner's Schedules C (profit and loss from business) (https://www.irs.gov/pub/irs-pdf/f1040sc.pdf) and Schedule SE (self-employment tax) (https://www.irs.gov/pub/irs-pdf/f1040sse.pdf).

What Is Passive Income vs. Earned Income?

When the income derived by the business comes as the result of some form of labor, then the income is classified as earned income. Earned income is subject to FICA (Social Security) and Medicare taxes.

However, sometimes income from the business does not involve labor, such as when a business's income comes from charging rent to a tenant. When the income is not the result of labor, the income is considered passive income, and as a result, it is not subject to FICA or Medicare taxes and is reported on Schedule E of the individuals 1040 tax return.

Even within a single entity, sometimes the income may be considered earned income if the owner works more than 500 hours in the business or it might be considered passive income

When an owner's income is considered earned income, that owner has some options for tax deductions such as healthcare or retirement contributions that owners who receive passive income do not. Of course, the owners with earned income then subject that income to FICA and Medicare taxes.

What Are Self-Employment (SE) Taxes?

As an employee, we are used to having 7.65% deducted from our net income as our part of our FICA and Medicare tax contributions. What you don't see as an employee is that the employer is obligated to match your FICA and Medicare tax contributions.

When your income from the business is considered earned income (therefore subject to FICA and Medicare taxes) and you are also an owner of the business, then you are both the employee and employer in the eyes of the IRS. As a result, you must pay both the employee and the employer portions of FICA and Medicare taxes. When we talk about self-employment, or SE taxes, we are including both the employee (7.65%) and employer (7.65%) portions of the FICA/Medicare contribution for a total of 15.3%.

How to Get Paid as an Owner of a Sole Proprietor or Single Member LLC

As a sole proprietor or as a single member LLC you are the only owner, and as a result, you do not take a salary or a wage from a business. Instead, you can simply withdraw money from the business, which is known as an owner draw, to pay yourself.

As a sole proprietor or single member LLC, the taxes you are obligated to pay are based on the profits of the business. As you will recall, an owner draw is simply a mechanism that allows you, as a single owner, to take out excess cash from the business. Therefore, owner draws do not have any income tax consequences to you.

As a lifestyle or micro business with a single owner, you only need to make sure there is enough cash in the business checking account to cover all

non-discretionary expenses. All other money is at your discretion to either take out as a periodic owner draw on profits or leave in your business as excess cash or use to pay discretionary expenses in the hopes of growing your business. If you are at risk of being overdrawn because your business expenses exceed your income, you will have to do a cash infusion to make sure your non-discretionary expenses get paid.

The P&L is an internally generated document used to record the profit or loss of a business for income tax purposes. Since there is only one owner, there is no need for the business to file an informational tax return with the IRS. All tax filings for the business are recorded through a Schedule C (profit or loss from business) (https://www.irs.gov/pub/irs-pdf/f1040sc.pdf) on your personal Form 1040.

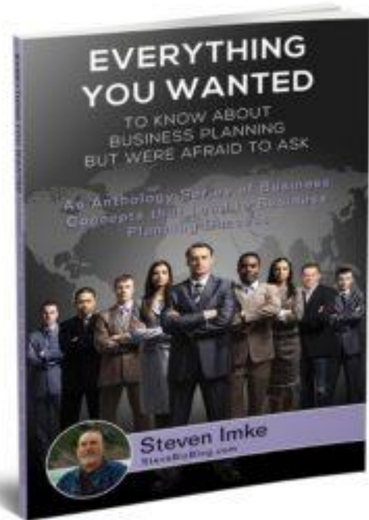
At the end of the tax year, you will simply use your business's P&L to complete your Schedule C. Assuming you made a profit, 100% of the net profits from the business are considered earned income, and therefore, it is subject federal and state income tax based on your marginal tax rate. Additionally, 100% of your net profits are also subject to self-employment tax (15.3%) since you are considered the owner and manager. You will report your self-employment tax in a Schedule SE (self-employment tax) (https://www.irs.gov/pub/irs-pdf/f1040sse.pdf) on your personal Form 1040.

While the draws you use to pay yourself out of business profits throughout the year are not taxable, the year-end profits of the business are and you will need to make estimated tax deposits. When it comes to SOLE PROPRIETOR and SMLLC's, the onus is on you to estimate the taxable income you will receive from the business and then make quarterly deposits to the IRS using Form 1040-ES (https://www.irs.gov/pub/irs-pdf/f1040es.pdf) to cover the anticipated annual tax liabilities. The same is true for your estimated state taxes. To avoid IRS penalties, your tax estimates should add up to at least 90% of your estimated tax liability.

Are you paying yourself properly as the owner of sole proprietor or single member limited liability company?

I would like to acknowledge Karen Absher of KSA Financial & Tax Services (http://ksafintaxsvc.co/) for her gracious assistance as a reviewer to make sure that the tax issues conveyed in this paper were an accurate representation of US tax law.

If you enjoyed this paper I recommend that you check out my book:



Everything You Wanted To Know About Business Planning But Were Afraid To Ask

An Anthology Series of Business Concepts that Lead to Business Planning Success

This is not another business book designed to help you write a business plan. The focus of Everything You Wanted To Know About Business Planning But Were Afraid To Ask endeavors to convey all the business wisdom you need to know BEFORE you sit down to write a business plan.

Readers will learn:

- What factors to consider before they start
- The vocabulary and federal acronyms of business
- How to define the right business model and economic model for your business
- How sales taxes and income taxes work
- How your credit score is computed and what you can do to improve it
- About business risk and how to minimize it
  How to benchmark your financial projections against other existing businesses
- How to fund your business even when the banks says no
- How different customers think so you can better market to them
- About basic business management structures
- The seven most common business formations errors
- How to get the most out of employees

As a serial entrepreneur and mentor to thousands of small businesses, the author has distilled a lifetime of business wisdom that every new entrepreneur should consider before they sit down to write their first business plan.