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# S-corporation Shareholders need to take a reasonable salary

Hey Dan "the tax man", My tax preparer says I can convert to an S-corporation from being a sole proprietor and not have to pay the self-employment tax anymore. Is that true?

Well, in a way that is true. Self-employment tax is the social security and medicare tax that are withheld from your paycheck as an employee plus the amount your employer matches. The very nature of an S-corporation means that there is no self-employment tax on the same profit that would occur for sole proprietors. You would only pay income tax on the net taxable income of the S-corporation. In addition, you are able to take distributions of profits without paying any other taxes (vs. double taxation in C-corporations). However, this also means that you are no longer paying into Social Security or Medicare and the IRS understands that this happens.

The IRS has a Revenue Ruling and many court cases that allow them to reclassify some of these distributions as wages for shareholders of an S-corporation that do not take a reasonable salary. You don't want to be caught in this situation if your return were to be audited. If they reclass the distributions as wages, you now owe payroll taxes (i.e. the same as the self-employment tax) to the extent they have reclassified those wages (plus penalties and interest).

The way you avoid this is to pay a reasonable salary. Of course you ask, "How much is a reasonable salary?". Of which I say to you "It depends". Don't you just love that answer. First, you can look to industry data that shows what a person who holds the same title(s) that you have in a similarly sized company. Then look to the amount of profit that you are expecting for the year. Rule of thumb is that whatever your total profit is for the year, your compensation should not be less than one-third or more than two-thirds of the total amount. This is a general rule as there are no written guidelines from the IRS or Congress.

Example: You own a small dental practice and you expect to have a profit of $150,000 for the year. If dentists who are owners of their own business who have a similar sized practice pay themselves a salary of $75,000 to 100,000, then you should pay yourself a salary in that range. In this case, you should most likely not pay yourself less than $75,000 due to the industry data, unless you can justify it by discussions with your tax advisor.

Also, keep in mind that if you are taking a salary then you will have federal withholding paid in on the wage paid. In addition, you should be paying estimated tax payments toward the tax on the profit you are not taking as a salary (i.e. salary of $75k has withholding and the other $75k does not have any payments unless you make the estimated tax payment).