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Business owners need to understand the tax implications of how they draw income from their businesses. This is a complex topic, but let's start with a quick overview of options.

Sole proprietors are considered employees and get paid by drawing money from the business. No FICA taxes are taken from these draws, but sole proprietors will pay what is called self-employment taxes on their individual tax return by the income generated by the business. A partner takes distributions from the profits in a partnership. A partner's distributive share of the profits will flow through to the partner on a K-1, which will then be reported on their individual income tax return. Some partners may receive a guaranteed payment, which is similar to a salary and is subject to self-employment taxes. If you own an LLC, you do not take a salary, but instead take a draw, similar to a sole proprietor.

You have more freedom in deciding when you take distributions from the company with all of these options, but it also necessitates the need for careful tax planning. Often, business owners will pay quarterly estimates to avoid large balances due and/or underpayment penalties on their individual tax return, which will occur if taxes are not paid in throughout the year. It is best if you have a personal tax planning strategy to help minimize your tax burden as much as possible.

Where things get more complex is when your business is structured as an S or C corporation. Here are five things to consider related to corporations.

1. First, as a business owner in an S corporation who is involved in the day-to-day operations, the IRS says you are required to take a reasonable salary and pay the required employment taxes on that salary. These taxes include FICA payroll taxes and federal unemployment taxes.
2. Guidelines for how much you should receive as a reasonable salary is provided by the IRS. If you underpay yourself, you could face IRS fines. But, if you overpay your salary, you may be paying more taxes than you need to. Be sure to review the IRS reasonable compensation rules to guide you in determining your salary.
3. In an S-corporation structure, you can also distribute profits from the business, which avoids employment taxation. Those distributions should be planned carefully to ensure enough is left in the company to pay employees, loan commitments, and other business expenses.
4. In a C corporation, the corporation and owners pay taxes on dividends they receive. If you are actively working in the company, you should draw a salary, but you can also receive dividends.
5. Work with an experienced accounting firm to model out the options that afford you the best tax-advantaged way to draw your business income.

This is definitely not a one-and-done exercise and compensation should be reviewed every couple of years to ensure the plan still fits your personal and business needs.