How To Pay Yourself: From Startup and Beyond

Determining your salary is one of the most important decisions you'll make as a business owner. Here's how to do it.

It's an age-old conundrum that faces every entrepreneur planning their business: What do I pay myself? There are a lot of different theories when it comes to this issue, but the two most common for startups are:

1. Pay yourself enough to get by. At least during startup until you are operating in the black. The argument here is to minimize your overhead in order to decrease the amount of capital required to make your business a success. Also, by reducing your overhead, your net loss will decrease or your net profit will increase, providing the business with lean operating requirements until it is well established.

2. Pay yourself what you are worth. Build that into your business plan so you have an accurate portrayal of how much capital you will need in order to finance your business. By paying yourself what you are worth, you aren't painting an artificial portrait of the business that will change once you reach the black--operating costs will remain the same.

So how do you know what is enough to get by and what you are worth? You have to do some planning and simple mathematics, and then budget that amount into your income and cash-flow projections so that you know how much operating capital you will require during the formative stages of your company's development.

What happens when you reach break-even and grow beyond that point? There are many factors that go into the equation, such as legal form of operation and tax requirements. You need to balance your needs against what you feel you are worth, what you need to get by, what the business will be able to sustain, and how your income as well as the business will be taxed.

Projecting Your Salary
As we mentioned, there are two methods you can use to determine your pay during startup. The first is paying yourself enough to meet basic living requirements. Depending on your situation, that means enough income to cover your bills, food and other miscellaneous living expenses. Strike all other discretionary items from your life for a while and get used to just the bare necessities. If you are used to dining at fine restaurants seven days a week, get used to going down to the local McDonald's maybe once or twice a week.

To begin planning your pay, you need to put together your own personal financial statement that lists all your living expenses and any credit cards with outstanding balances as well as short-term and long-term loans. This may be one of the most difficult

things you've ever had to do because you don't want to leave anything out. You want to make sure that your income from the business will be enough to cover your expenses.

The personal balance sheet should include a list of common items you'll need to consider when determining your monthly living expenses. Generally, if you can pay-down any debts before going into business, you'll not only decrease the amount of income you'll require each month, but also improve your personal net worth, which is important when it comes to borrowing capital to fund your business.

Once you've listed amounts for each of the items on your monthly budget, add them all together. This is the amount you will need to pay yourself in order to meet your basic requirements. Remember when putting together your list to include all your expenses. That doesn't mean just monthly, but quarterly, semiannual and annual expenses. You must provide yourself with complete information. After all, you will be living on this income for at least six months to a year.

The other system from which you can project your salary is basic worth. How much do you feel you are worth? That's a very subjective question. After all, what you feel you are worth may not be what your value is on the market. Of course, many people go into business for themselves because they want to achieve a degree of financial security for themselves and their families. Naturally, you're going to assume that you will pay yourself a basic minimum of what your current market value is plus a little more. And that is exactly how you will set up the equation to determine what your monthly draw will be from the business.

To determine your basic worth, start by writing down your current salary or hourly wage. That is what your market worth is at this point in time. This is what you want to make at a minimum going into the business. But market worth isn't basic worth. There is a difference. Basic worth is your market worth plus a percentage increase based on three to four times the rate of inflation.

Why is there a percentage increase from market worth? As we mentioned, market worth is a minimum, a starting point. It doesn't take into consideration the increased responsibilities of running a business and your value to the business as its owner. With these factors taken into consideration, your basic worth is determined using the following equation:

(MW (12) [1 (I (4) = BW

In this equation, market worth (MW) is your total annual pay minus any bonuses or overtime. Divide the annual market worth by 12 to get a monthly amount. Then multiply this by the inflation percentage (I) multiplied by 4.

For instance, suppose you are making $15 per hour at your current job. At $15 per hour, your annual pay would be $31,200. Your annual pay of $31,200 would then be divided by 12, resulting in a monthly income of $2,600. At the time you are determining your

basic worth, the rate of inflation is four percent. Multiply four by four, and the percentage which you will add to your current monthly income is 16 percent. Your basic wroth would be $36,192 annually.

Of course, these are just recommended models to use when determining what you will pay yourself during the period of startup to break even. You can use any type of system you wish. The idea is to provide you with a realistic figure that's fair and equitable.

Break-Even and Beyond
Determining your salary during the planning stages of startup is important because you need to include your income in the financial statements you will produce in order to obtain financing for your business. Even if you are financing the venture yourself, you need to have this information in front of you; otherwise, your overhead won't be practical and any income, break-even and cash-flow projections you will perform will be inaccurate.

Any bank or investor looking through your plan will check your financials very carefully. They're going to look at these projections to make sure you can repay the loan from the profits of the business. If they hold equity in the business, they need to determine how great a return they can expect from their investment. They're going to check the cash-flow projection to make sure you have enough to cover your own draw and living expenses until the company is profitable, unless, of course, you have a separate income.

Keep in mind that during the first year of business, it typically takes three to six months to break even. Once you reach break-even, though, do you change your salary? If you think you can, then you will make one of the most common mistakes an entrepreneur can make.

Just because you've reached break-even, that doesn't mean your company is profitable, or is even stable. If you're paying yourself just enough to get by, raising your salary is going to increase your overhead, which will require a greater amount of revenue from the business in order for expenses and income to match. In other words, you've just thrown your business into the red again. If you're paying yourself your basic worth, then you shouldn't need to raise your salary, at least for a while.

After you've reached break-even, the best method to increase your pay is to tie any income above your fixed salary to the growth of the business. Therefore, if the company grows 10 percent during the first quarter after break-even, take your base salary and add a 10 percent bonus to it.

Continuing with this example, if your base salary is $3,016 per month as determined in our example of basic worth, you would multiply that number by three (the number of months in a quarter) and add 10 percent. Therefore, you have:

(3,016 (3) (10 percent = $905

You would give yourself a bonus of $905.

After your first full year in business, once you've passed break-even, reevaluate your business to determine its annual growth and increase your salary accordingly. As an example, suppose company sales have grown 50 percent during the first year after break-even. Your current salary level is $36,192, based on the basic worth example. Multiply that salary by 150 percent and you will come up with your new annual pay, $54,288. You can retain the bonus income after the first year of break-even if you like. After all, why not compensate yourself for the increased performance of your company?

There are, of course, other factors you need to consider when determining pay. For instance, what happens when the rest of overhead, excluding owner compensation, grows faster than the rate of sales on a percentage basis? Most of these expenses are required in order to operate your business. Sure, you may be able to trim a little fat from the budget by removing any discretionary purchases, but the fact remains that if overhead grows at 12 percent, and sale grow 10 percent, it is only a matter of time before you find yourself in trouble. By increasing your base salary by 10 percent, the rate of sales growth, you are only hastening this crisis.

In order to keep your total overhead, including owner compensation, at a comfortable level in relation to income, you will have to take that rise in overhead into consideration when you determine your salary level. To do this you need to determine how much your overhead is, excluding your salary. For instance, suppose your annual overhead minus owner salary is $180,960, your salary is $36,192, and sales are $312,000. If you add during the first year after break-even, the company's sales grow by 10 percent of sales. Now, but overhead minus owner salary grows by 12 percent to $202,675, or about 60 percent of total sales. Your raise in pay cannot exceed 70 percent, so you will be unable to give yourself a 10-percent raise unless you want to cut into your profit. Instead, you would give yourself a four-percent raise for a total of $37,600 annually.

Keeping your costs under control means checking rapid growth of your overhead costs. But no matter what you do, overhead will rise on annual basis due to inflation alone. Your objective is to try and keep it in line with the growth of sales.

A lot of people fail to realize that when you're self-employed, the legal form under which you operate your business directly affects the way the IRS views your tax status and, therefore, will have some bearing on how you pay yourself.

The easiest way to get into business is as a sole proprietor. A sole proprietor doesn't have any partners to worry about, nor a corporate identity to hide behind. As a sole proprietor, the buck stops at your desk and nobody else's. If you get tagged with a lawsuit, you face the liability. It's as simple as that.

On the other side of the coin, if your company does well, you reap the profits. Under a sole proprietorship, profits from the business and your personal income are treated the same by the IRS. There is no distinction.

After deducting all your overhead expenses on Schedule C of Form 1040, the resulting profit is your income and you are taxed on that portion, including a tax for social security under the Federal Insurance Contributions Act.

A partnership is a totally different vehicle from the sole proprietorship in terms of operations, but from the point of view of the IRS they are practically the same. Any profit generated through a partnership is treated as personal income. Instead of completing Schedule C of Form 1040, however, partnerships must file Form 1065, U.S. Partnership Return of Income. This lists all expenses that can be directed against income to arrive at the taxable income generated from your business. Schedule K-1 should be sent to each partner to help them report their share of the income on Form 1040. You do not need to file Schedule K-1.

If your business is organized as a corporation, you will get paid a salary like other employees. Any profit the business makes will accrue to the corporation, not to you personally. At the end of the year, you must file a corporate income tax return.

Corporate tax return may be prepared on a calendar- or fiscal- year basis. If the tax liability of the business is calculated on a calendar year, the tax return must be filed with the IRS no later than March 15 each year.

Reporting income on a fiscal-year cycle is more convenient for most businesses because they can end their tax year in any month they choose. Pursuant to the 1986 Tax Reform Act, a corporation whose income is primarily derived from the personal services of its shareholders must be a calendar year end for tax purposes. In addition, most Subchapter S corporations are required to use calendar year ends.

The salary you receive from the corporation is, of course, reported as your own personal income on Form 1040. As the CEO of a corporation, you'll be able to plan your salary with an eye toward tax rates. You may be able to set up a staggered fiscal year, differing from the calendar year by which individuals are typically taxed. You may accrue or defer income between the corporation and yourself so you can stay in the lower tax bracket consistently. You can zero out the income of the company. In other words, make sure the corporation doesn't have any income outstanding at the end of the year.

How can you achieve this? Pay salaries that will absorb whatever profits there are in the company. There is a limit to how much of this you can do, and in most states you have to document the process with appropriate resolutions and directors' meetings. But for most small companies not making a tremendous amount of money, it makes sense to pay income out of the corporation in the form of salary.

There is a danger to this strategy, especially when it comes to awarding big bonuses to yourself. If you're the owner of a small, privately owned C-corporation, the IRS will look closely at returns to determine if there is "excessive compensation" to lower the tax liability of the company. If the IRS determined the bonus, in addition to your regular salary, is too large, they'll disallow the deduction of the bonus as an expense to the corporation. In addition to the loss of the deduction, increasing the amount of tax to be paid, the IRS will also charge you interest and, more than likely, penalty fees. There is also a possibility that the IRS may establish the excessive bonus as a dividend payment, which will cause that payment to be "double-taxed" to both the corporation and your personal taxes.

No matter which legal form you choose, it's vital that you discuss this decision with your tax accountant or attorney to make sure you're operating legally and getting the best deal on your taxes.

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