Maximizing an S Corp. retirement plan

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Individuals who are the sole owner and employee of their Sub Chapter S Corp. are always faced with the issue of how much of the income should be distributed through wages versus how much can be distributed in cash. The IRS wants the shareholder to pay himself a reasonable salary. Conversely, the shareholder may not want to incur any payroll taxes, so their inclination is to report the S Corp. income on their individual income tax return, and take the cash generated by that income out of the corp. through distributions.

One way to satisfy both objectives is to put the sole shareholder/employee on payroll and adopt a Solo 401K plan. The shareholder may want to establish his annual compensation at a level equal to or slightly higher than the Social Security tax limit in effect for the year. This would minimize the risk of an IRS audit re-classifying distributions as wages. Such an action would result in a penalty assessment up to a 100% for failure to withhold and remit payroll taxes. That is true because the only additional payroll tax exposure to be gained through re-classification, would be the 2.9% combined medicare tax.

Once a Solo 401K plan is adopted, the employee can contribute up to $15,500 or 100% of compensation whichever is lower. The employer can then contribute up to 25% of compensation not to exceed a combined contribution for the 2008 tax year of $46K. This translates to a salary of $122K which satisfies the bulk of the payroll tax exposure while maximizing the contribution to the S Corp.'s retirement plan. In addition, the $30,500 employer contribution and the payment of the unemployment taxes reduce the S Corp. income, thus reducing the income reflected on the shareholder's return.

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