How Much Should You Pay Yourself As Salary?

Incorporating yourself is a good way for many doctors to save themselves a few thousand dollars in Medicare taxes. The reason why is that once you incorporate, some of your take-home is salary (which is subject to Medicare tax) and some of your take-home is business profit, (which is not). At 2.9%, every $100K you call business profit instead of salary is worth $2900 off your tax bill.

A Reasonable Salary

So the temptation, of course, is to call all your take-home money business profit and NONE of it salary. As you might imagine, that's not going to fly with the IRS. The IRS expects you to pay yourself a reasonable salary, or one for which you'd go do the same job for someone else. Unfortunately, that's about the only guideline they give you. Apparently, people are willing to do the same job as me for a wide variety of salaries. For example, in the military, I did the job for a taxable salary of something like $80,000 a year. A recent emergency medicine salary survey of physician employees showed the 10th percentile at $205K and the 90th percentile at $384K. That obviously leaves a very broad range of the number you want to use for your salary. If your group also hires moonlighters, you could also use the rate at which you hire them for your salary. Basically, the key is that whatever figure you use, you have to be able to justify it to the IRS.

The 50% Rule

I met with a CPA recently, and she notes that auditing of an S Corp is pretty darn rare and she's never heard of a doctor being audited on this particular point. But she recommended that you pay yourself no less than 50% of your take home as salary and suggested a range of 50-70% of your take-home should be salary. The theory, she stated, was that some of your income is from being a prudent manager of the business and for taking on that business risk. But in emergency medicine, most of your income comes directly from your own patient care fees, not from other business income. I think if you were a family practice doctor with 3 PAs working for you and selling some supplements on the side, you could justify a lower percentage of your income being salary than a shift-worker like an emergency doc could. But the point is that whatever you pay yourself, you'd better be able to have some kind of data to justify that number if the IRS comes asking. When they do audits, they start with those people who pay themselves 0% in salary and work their way up from there.

Retirement Plan Effects

A more important factor for me was the effect on how much I could sock into a retirement plan. Business profit can't be used to determine the amount you can contribute to your 401K or SEP IRA, only salary can. If I want to max out my 401K with $50K ($55K if over 50), then I need a salary to justify that contribution. You have to do some calculating to figure out the exact amount. For a self-employed doctor, it turns out the number is higher if you use a SEP-IRA than a solo 401K. That's because with a SEP-IRA you can only contribute between ~19% of your salary to a retirement plan. With a solo 401K, you can contribute $17K as the employee contribution, and then ~19% of your salary can be contributed as an employer contribution

If you run the numbers for 2012, it turns out that if you want to maximize your SEP-IRA, you need an income of $259,717 ($21,643.08 per month). For a 401K, that number is $173,564 ($14,463.67 per month). Although a Solo 401K is a little more complicated to use than a SEP-IRA, for an incorporated doctor making more than $259,717, there is a possible tax savings of $2498 a year for doing so. Not to mention the opportunity to use a Backdoor Roth IRA that you can't do with a SEP-IRA. If you'd like to do these calculations yourself, use the worksheet in Pub 560, page 22. An easier way is to use this handy calculator which for any given income, will tell you how much you can put into a 401K/profit-sharing plan and how much you can put into a SEP-IRA.

It turns out my situation gets even more complicated. Since my corporation would be a partner in a partnership, my corporation would have to use the partnership's 401K plan. So I am subject to the partnership 401K rules, which, although still a little unclear, probably means I would need to pay myself a salary around $250K in order to max out the 401K, dramatically decreasing the benefits of incorporation for me.

[Update 1/17: If your entity is an S Corp or an LLC filing as an S Corp, your business can make an employer contribution to a 401(k) of 25% of your W-2 wages. While this means the business needs to make just as much money as a sole proprietorship in order to max out a 401(k), the employer contribution is not subject to payroll taxes, so there is a savings there of about $1000 a year in Medicare tax for most docs.]

Obamacare Tax

One other great reason to keep your salary down is to avoid the new 0.9% "Obamacare" additional Medicare tax on high earners. It is levied as 0.9% of every dollar you earn (as salary) over $200K ($250K married). If your salary is $173K, you won't have to pay any of that tax, even if you take home an additional $150K as "business profit."

Incorporation isn't necessarily the huge tax savings it is sometimes cracked up to be, but for many doctors, the benefits outweigh the costs in time and money. This is obviously all pretty new to me, so post in the comments below how you decided how much to pay yourself as salary and why.

Have you incorporated? What do you consider a reasonable salary? Have the benefits outweighed the costs? Comment below!