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Guaranteed Payments: Equivalent of Salary for LLC Members and Partners

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Absent special elections to be taxed differently, partnerships and limited liability companies (referred to herein as “entities”) with two or more partners or members (referred to herein as “owners”) are taxed on a pass-through basis for purposes of federal income taxes. Such entities are not subject to a direct federal income tax. Instead, when the entity receives income, this income is passed through to the entity’s owners for tax purposes on their individual tax returns. Each owner then pays taxes on his or her “distributive share” of this income. Instead of receiving this income from the entity in the form of wages, the owners generally receive a payout of this income in the form of a capital distribution.

Such distributions are payments that the entity makes to its owners in respect to their ownership of it. Generally, the amount of the distribution to which an owner is entitled is determined based on their percentage ownership interest in the entity relative to the other owners. For years where an entity does not make a profit, the entity generally will not make a distribution to its owners. This may be problematic where an owner is heavily involved in the day-to-day operations of the entity and needs a steady stream of income on which to live or where the owner’s percentage ownership interest does not reflect the actual value he or she brings to the entity in terms of experience, time commitment, or other expertise. These times may call for a guaranteed payment.

Guaranteed payments are payments that an entity makes to an owner whether the entity makes a profit or not. Unlike distributions however, even if the entity loses money in a year and does not pay any profits out to its other owners, the owner who gets a guaranteed payment will still be compensated for his or her work that year. In this way, the guaranteed payment for a partnership or an LLC is the functional equivalent of a salary to a shareholder-employee in an S or a C corporation. Like a salary expense, the guaranteed payment is treated as an expense to the entity and may pass-through as a deduction to the entity’s owners. It factors into the performance of the entity, so that to the extent any net income isn’t paid out to the owners as a guaranteed payment, this excess net income is typically divided among the owners as a distribution.

Owners are subject to self-employment tax on guaranteed payments and their distributive share of income. The entity will not withhold taxes on either of these payments, and the owners will need to file estimated income tax returns. As mentioned above, guaranteed payments are typically deductible by the entity on Form 1065 as a business expense. They are also listed on Schedules K and K-1 of the partnership return. The individual partner reports guaranteed payments on Schedule E of IRS Form 1040 as ordinary income, along with his or her distributive share of the partnership's other ordinary income.

Overall, those startup owners who need the assurance of a consistent salary-type payment that might not be proportionate to his or her percentage ownership interest of the company need not insist on using an S corporation or C corporation through which to do business. Instead, such owners should consider whether an LLC or partnership is still the best entity for them in light of the fact that a guaranteed payment could be used to accomplish their compensation goals.

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