S Corporation
Reasonable Officer Compensation

- All audio is streamed through your computer speakers.

- There will be several attendance verification questions during the LIVE webinar that must be answered via the online quiz at the conclusion to qualify for CPE.

- For the archived/recorded version of this webinar, the link to the attendance verification quiz is a final exam on the topics covered during the presentation.

“Is it Reasonable?“
Lesson Overview

- What is unreasonable salary
- What is unreasonable salary for SSA
- Who is an employee
- 9 Factors used by Courts
- Factors used to determine compensation
- Shareholder loans
- Income to family members
- Court cases
- Case studies

Reasonable Compensation

- The IRS has recently indicated there will be audit initiatives for S Corporation officer compensation
- Lack of shareholder compensation on an 1120S tax return is a major “red flag”
- Andrew has already experienced it!
- Rev. Rul. 74-44,1 – IRS may recharacterize dividends as wages
Reasonable Compensation

➢ S Corporation shareholders think “No Double Taxation” means “No Payroll Taxation”

➢ S Corporations are pass-through entities, however there Must be reasonable compensation

➢ Lack of officer compensation is a disaster not a savings!

What Is Unreasonable Salary?

➢ Zero salary is unreasonable

➢ Nobody works for FREE!

➢ Salary below minimum wage is unreasonable

➢ Salary in excess of appropriate wage is also unreasonable
What Is Reasonable Salary?

- This is the million dollar question!
- IRC states distributions and other payments to a corporate officer for services must be treated as wages
- There are no specific guidelines for reasonable compensation, thus allowing abusive practices by S Corps

Taxpayers Love Unreasonable Compensation

- S Corporation dividend distributions are Not subject to Self-Employment Tax (SECA)
- Not subject to Federal Unemployment Tax (FUTA)
- Not subject to State Unemployment Tax (SUTA)
IRS Loves Unreasonable Salary

- IRS won’t hesitate to recharacterize distributions to compensation
- Penalty for failing to pay employment taxes is 100% of taxes owed!
- Penalties are not tax deductible
- They add up quickly & IRS loves it!

SSA Loves Unreasonable Compensation

- Social Security Administration (SSA) is concerned with S Corp Officer Compensation
- Can recharacterize dividend distributions to compensation
- Can reduce Social Security benefits
FS-2008-25

- IRS issued Fact Sheet-2008-25 – August 2008  (Warning for S Corporation shareholders)
- FS-2008-25 reiterated the factors to be considered for determining reasonable compensation
- Outlines that corporate officers are employees for FICA, FUTA, Federal Income Tax under the IRC

When Should There Be Payment?

- When services are performed for the corporation; and
- Shareholder receives or is entitled to receive payment;
- The compensation is considered wages; and
- It is taxable for Federal Employment taxes
Who Is An Employee

- Shareholders are employees if they perform services
- Can they perform different types of services?
- Can there be different levels of compensation?
- What are the determining factors for compensation?

9 Factors Considered by Courts

1) Training and experience
2) Duties and responsibilities
3) Time and effort devoted to the business
4) Dividend history
5) Payments to non-shareholder employees
9 Factors Considered by Courts

6) Timing and manner of paying bonuses to key people

7) What comparable businesses pay for similar services

8) Compensation agreements

9) The use of formulas to determine compensation

Training and Experience

➢ What type of training does shareholder-employee have?

➢ What type of experience does shareholder-employee have?

➢ What level of education does shareholder-employee have?
Duties and Responsibilities

- What type of duties does shareholder-employee have?
- What is he/she responsible for? (Management, daily operations, clerical)
- How do the duties and responsibilities compare to other employees in the business?

Time and Effort Devoted

- How much time is dedicated to the business?
- Is documentation available for the various duties performed?
- Is the time devoted for major or minor services?
Dividend History

- Is there consistency in issuing dividend payments?
- How often are dividends paid?
- How much is each dividend payment?
- Is there a formula used to compute dividends?

Payments to Non-Shareholder Employees

- Does business have non-shareholder employees?
- What type of services do non-shareholder employees perform?
- How do they get compensated?
- How often do they get compensated?
Timing & Manner of Bonus Payments to Key Employees

- Do all or some employees receive bonus payments?
- If so, how often are bonuses paid?
- How are they determined? Is a formula used?
- Are they performance based, or position based?

What Do Competitors Pay For Similar Services?

- What do other businesses in the industry pay for similar services?
- What do other businesses in the local vicinity pay for similar services?
- How does shareholder’s compensation compare to competitor’s and industry?
What Do Competitors Pay For Similar Services?

- Check competitor and industry compensation regularly
- Salaries and compensation change as economic climate changes
- Would your competitor hire you for what you pay yourself?

Compensation Agreements

- Are compensation agreements used with non-shareholder employees?
- Is there a compensation agreement executed by shareholder-employee?
- Does compensation agreement clearly outline duties, responsibilities, wage compensation, and dividend distributions?
Using Formulas To Determine Compensation

➢ Are formulas used to compute compensation for shareholder-employee?

➢ Is it the “60-40” Rule?

➢ Is the formula used consistently?

➢ Does it provide for reasonable compensation?

Other Factors to Consider

➢ Health and accident insurance premiums

➢ Loans between corporation and shareholder

➢ Expenses paid by shareholder using personal funds

➢ Income allocation to family members
Health & Accident Insurance Premiums

➢ Does business pay health & accident premiums on behalf of greater than 2% shareholder-employee?

➢ Is coverage in the business or shareholder’s name?

➢ Are the payments reported on shareholder’s W-2?

Health & Accident Insurance Premiums

➢ Greater than 2% shareholder premium payments should be reported on W-2

➢ Not taxable for FICA or FUTA taxes

➢ Mandatory reporting on W-2 effective January 2013
**Health & Accident Insurance Premiums**

- Notice 2008-1 – Revised regulations for health coverage plans. Policy doesn’t have to be in S Corporation name

- Still deductible even if health coverage is in 2% shareholder’s name. It’s considered to be established by S Corporation

- S Corp can pay health insurance premiums or reimburse shareholder and take deduction

**Shareholder Loans**

- Shareholder loans are allowable

- Must be repaid with Reasonable Interest

- Paying interest legitimizes loan as Arms-Length transaction

- Not paying interest can be construed as Capital Contribution
**Shareholder Loans**

- Loans must be in writing – Formal Note between corporation and shareholder
- Reasonable interest must be paid
- Compare interest rates from local banks to get market rate
- Interest expense is deductible for the business

**Shareholder Loans**

- No interest can be construed that debt is contingent upon corporate profits
- Debt contingent upon corporate profits is considered a second class of stock
- Second class of stock terminates S Corporation Election!
- Busting up S Corp turns it to C Corp – Double Taxation!
Expenses Paid by Personal Funds

- Expenses paid with shareholder’s personal funds should be reimbursed with company check

- Expense reimbursement form should be completed for documented expenses

- Expenses charged on shareholder’s personal credit card should be well documented

Income Allocation to Family Members

- Shifting S Corporation income to family member shareholders in a lower tax bracket

- Helps reduce tax liability for shareholder

- Great for estate tax planning, but not great for shareholder compensation issues

- IRC Section 1366(e) – Gives IRS authority to make adjustments
Hobby – Loss Issues

➢ Is there a reason why business can’t compensate shareholder for services year after year?

➢ Is the shareholder not getting compensated because business is a hobby; or

➢ Because the owner is a bad business person and can’t turn a profit?

S Corporation Court Cases

➢ Roob vs. Commissioner (Court upheld IRS reallocation of dividends – Taxpayer failed to present evidence salary was reasonable)

➢ Rocco vs. Commissioner (Court ruled in favor of taxpayer – Salary was reasonable even with large dividends)

➢ Davis vs. Commissioner (Court ruled in favor of taxpayer using comparability test – Paid comparable salary to industry)
S Corporation Court Cases

- Ludeking vs. Finch (Court ruled in favor of SSA to reclassify dividend distributions)

- Herbst vs. Finch (Court ruled in favor of taxpayer – SSA couldn’t reclassify salary)

- Weisenfeld vs. Richardson (Court ruled minor wages were not substantial services – SSA lost)

S Corporation Court Cases

- Bianchi vs. Commissioner (Court ruled compensation was excessive – reduced pension contribution)

- Joseph Radtke vs. U.S. (Court ruled no salary was paid by Attorney – shareholder)

- Spicer Accounting vs. U.S. (Court ruled no salary paid by Accountant - shareholder)
Case Study – Sanders Corp

1) $100,000 in W-2 Wages
   - Employer FICA @ 7.65% $7,650
   - Employee FICA @ 7.65% $7,650
   - Total Tax Liability $15,300

2) $10,000 in W-2 Wages/$90,000 in Distributions
   - Employer FICA @ 7.65% $765
   - Employee FICA @ 7.65% $765
   - Total Tax Liability $1,530

Case Study – Sanders Corp

- Tax Liability – Situation 1 $15,300
- Tax Liability – Situation 2 ($1,530)
- Tax Savings in Situation 2 $13,770
- Which would you recommend if your client asked for advice?
Case Study – Jones Printing Inc

“60-40” Rule - Danny Sole Shareholder
- Services provided by Danny
- Profits $100,000 (Are distributed)
- 60% Salary - $60,000
- 40% Distributions - $40,000

Is this reasonable compensation?

Case Study – Jones Printing Inc

“60-40” Rule – Danny Sole Shareholder
- Services provided by Danny
- Profits $100,000 (Not Distributed)
- 60% Salary - $60,000

Should Danny take $60,000 salary if no earnings are distributed?
**Tax Implications of Reclassification**

- Penalties from reclassification are **not** deductible
- Higher taxes for IRS if distributions are reclassified
- Amended 1120S and 1040 will be required
- Higher scrutiny if future years

**Case Study – Home Crafters Inc**

- $90,000 Net Profit – No Salary Paid to Melissa
  - Melissa provides services to Corporation
  - $50,000 Distributions Paid to Melissa
  - Employer FICA Savings @ 7.65% $3,825
  - Employer FUTA Savings @ 6.2% $434
  - Melissa’s FICA Savings @ 7.65% $3,825
  - Total Savings $8,084
Case Study – Home Crafters Inc

- IRS Audits and reclassifies $50,000 of distributions Melissa received
  - New Net Profit to Report on 1120S after reclassification
    - Net Profit before Reclassification: $90,000
    - Less: Salary Payment: ($50,000)
    - Less: Payroll Taxes: ($4,259)
    - Net Profit on 1120S Post Reclassify: $35,741

Case Study – Home Crafters Inc

- Melissa’s total income on her 1040 after reclassification
  - Net Profit: $35,741
  - Salary: $50,000
  - Total Income: $85,741

- Assume Melissa is in 28% tax bracket. She will pay $1,193 less in income taxes ($4,259 x 28%)
Case Study – Home Crafters Inc

➢ Melissa pays $1,193 less in income taxes

➢ However, U.S. Government collects $6,891 more in payroll taxes

➢ Total Payroll Taxes–S Corp/Melissa $8,084
➢ Less: Melissa’s lower income tax ($1,193)
➢ Net Increase in Taxes due IRS $6,891

Suggestions for Reasonable Compensation

➢ Distributions should be recorded in corporate minutes

➢ Distribution payments should be stated as a dollar value per share owned by shareholder

➢ Don’t make frequent distributions (Monthly)

➢ Distributions paid to all shareholders on same date
Suggestions for Reasonable Compensation

- Do Not pay personal bills through business and “call” them distributions
- Pay reasonable wages using comparable salaries with industry and position
- If business is losing money, don’t put borrowed money into business and pay it as distributions

Reasonable Compensation

- Always provide your client the worse case scenario figures
- Let them know in advance that it’s costly to not be Reasonable with the IRS!
- Be Reasonable – Stay Out of Trouble!