S-Corporations – What is Reasonable Compensation?

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In my 30+ years as a practicing CPA, I have yet to meet one business owner who likes to pay taxes; the opposite case is typically the norm. So when it comes to payroll taxes, the situation is the same – no one wants to pay payroll taxes. Luckily, there is quite a simple solution to not paying payroll taxes – don't pay yourself a salary. Rather take distributions which are not treated as wages. However, there is always another side to the coin – the IRS does not like this in the least (to say the least…).

Income from an S-corporation, which flows through to its shareholders is taxed at the individual level, and is normally not subject to self-employment (i.e. payroll taxes). Most S-corporations, however, have shareholders performing some type of service for the corporation as officers, employees, etc. When a shareholder/employee takes distributions from the corporation instead of a salary, they are taking the position that the distributions are being paid to them in their capacities as shareholders and, therefore, it is ok to take the distributions out of the corporation without paying any payroll taxes (which can easily add up to over 16% when considering the employer/employee portions combined – and this is the federal portion only!). The term "employee" includes an officer of a corporation - corporate officers are clearly employees, and any payments to them for performance of services are considered wages subject to payroll taxes.

All one needs to do is read the instructions to Form 1120S, which state "Distributions and other payments by an S-corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation." The IRS considers no or low salary to a shareholder an attempt to evade payroll taxes.

As previously stated, the IRS frowns (quiet heavily) upon no or low salary, and therefore assesses a penalty for failing to pay payroll taxes at 100% of the taxes owed. An S-corporation tax return that reports little or no compensation to a shareholder is an absolute red flag calling to the IRS to look closer. The IRS can and will go after the corporation and shareholder to collect payroll taxes on shareholder compensation. Furthermore, when the IRS comes knocking at your door, there is no "chart" or "reference table" to use to support the compensation paid, so the taxpayer and IRS most always disagree about the "correct" amount of compensation to be paid to the shareholder. In addition, since most S-corporations are family owned, there is not the concept of dealing with shareholder payments at arm's length. So when reviewing compensation, both the IRS and the courts look at the factors discussed below.

Did the shareholder provide substantial services?

IRS regulations indicate that an officer of a corporation who does not perform any services (or performs only minor services), and who neither receives nor is entitled to receive any remuneration, is not considered an employee of the corporation. Therefore, to determine if the officer is an employee, the services the officer performs must be reviewed. Examples of services are: active participation in management, negotiating contracts, obtaining financing, obtaining customers, reviewing the work of other employees, etc. FYI - - a slam-dunk win for the IRS is where the corporation has no employees, and the shareholder does all the work by him/herself.

Is the compensation reasonable?

Several factors determine reasonableness of compensation: the employee's qualifications; the nature, extent, and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid to others within the business; prevailing economic

conditions; comparison of salaries with distributions to shareholders; the prevailing rates of compensation paid in similar businesses; the taxpayer's salary policy for all other employees; and, in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years.

According to the IRS, the key to establishing reasonable compensation is determining what the shareholder did for the S corporation. So the IRS looks to the source of the S-corporation's gross receipts. If they came from services of non-shareholder employees, or capital and equipment, then they should not be associated with the shareholder personal services, and it is reasonable that the shareholder would receive distributions as well as compensation.

On the other hand, if most of the gross receipts and profits are associated with the shareholder's personal services, then most of the profit distribution should be allocated as compensation. In addition to the shareholder direct generation of gross receipts, the shareholder should also be compensated for administrative work performed for the other income-producing employees or assets.

Conclusion

Documentation is the key for taxpayers to justify their position in the event that the IRS questions distributions to shareholders. Have well-drafted employment agreements, use a consistent approach each year to determine pay and bonuses, and establish reasonableness by evidence of the company's gross sales and profits, the experience and competence of the shareholders, and the time devoted to the business. By doing so, taxpayers can show that their compensation plans were adopted in good faith, and that the distributions are in fact reasonable.