S Corporation Owner-Employees Must Report "Reasonable Compensation" for Personal Services or Face Significant Tax Penalties

By Daniel N. Janich

You are a small business owner doing business as an S corporation. You are an active participant in your business and may be its only shareholder. Largely, if not exclusively, through your personal efforts, your company finally turns a profit—perhaps even a handsome one at that. How should this income pass through to you? Is there any portion of the income that should be earmarked as compensation for your personal services rendered to the company? How should you treat the income to be passed through to you for tax purposes?

Not surprisingly, these questions are among the ones commonly raised by "hands on" business owners who have elected S corporate status for their companies. Getting accurate answers to these questions is critical to the very survival of your business and your overall financial well-being. This blog post examines the income tax pitfall that arises when an S corporation owner employee fails to give adequate consideration to the worth of his own personal services rendered to the company. I will address best practices on this issue, and how to avoid potentially severe income tax penalties if you cannot substantiate your tax position on the amount of income claimed as your wages.

The S Corporation "Pass Through" Advantage

One key advantage of adopting S corporation status rather than C corporation status for your business is the avoidance of double taxation on company profits. This is accomplished by virtue of the pass through of income to S shareholders. As a result, it is not surprising that electing S corporate status is becoming increasingly popular, particularly for small professional service business operations.

If you are among those "hands on" small business owners doing business as an S corporation, you might be tempted to "pass through" all company profits as a corporation dividend or as a return of capital, rather than allocating a reasonable portion of the distribution as your wages in payment for the personal services you rendered to the company. By treating company profits as a dividend or return of capital you can avoid payment of potentially costly FICA and FUTA taxes assessed on payroll income. But if you are thinking of actually doing this you should resist the urge. The IRS has made it quite clear that as an S corporation's shareholder employee you cannot simply ignore paying yourself a fair wage for your own services. As various court cases continue to demonstrate, a company's failure to pay reasonable compensation to an actively involved shareholder employee continues to be an IRS hot button issue.

The FICA & FUTA Tax Rules For S Corporation Shareholder Employees

The tax rules make clear an S corporation owner that renders substantial services to his company is an "employee" for FICA and FUTA purposes. This is true even if the S corporation shareholder claims to render services to the company as an independent contractor. In cases where the shareholder renders substantial services to the company without receiving any compensation the IRS wins and the shareholder loses.

The more challenging situation is where the shareholder recognizes a portion of the "pass through" distribution as compensation. The question that arises in such circumstances is whether the amount paid is "reasonable" for purposes of complying with the FICA and FUTA tax rules. If the IRS deems the amount insufficient, the shareholder runs the risk of incurring significant tax penalties.

The Tax Penalties

The following tax penalties may be assessed—in addition to requiring the preparation and filing of amended income tax returns, the payment of accrued interest on any additional income taxes due, and of course the payment of FICA and FUTA taxes that should have been paid previously—if your salary level is deemed to be unreasonably low:

- IRC Section 6656, which imposes a penalty equal to 10% of the portion of an underpayment of payroll taxes that is required to be deposited; and

- IRC Section 6651(a)(1), which imposes an addition to tax in the event that a taxpayer fails to timely file a Form 940 and 941 return. The addition is equal to 5% of such tax for each month or fraction thereof during which the return is delinquent, up to a maximum of 25%.

The IRS and Courts Focus Upon Several Factors When Determining "Reasonable Compensation"

The overwhelming majority of court cases that have addressed this compensation issue for S corporation shareholder employees have involved professional services corporations. This is not surprising insofar as the IRS has taken the view that such businesses generate profit primarily by the personal efforts of the employees, and therefore, a significant portion of the profits should be paid out in compensation rather than distributions.

How is an S corporation shareholder to know whether the amount of compensation the company pays him is "reasonable" in the eyes of the IRS so as to avoid tax penalties on audit? There is no "bright line" test that can determine "reasonableness" of compensation. Although legislative proposals over the years

would subject S corporations to payroll taxes on all distributions, which might render an individual "factual circumstance" analysis unnecessary, none of these proposals have been successful so far.

So the IRS and the courts generally continue to rely upon the following factors to make the assessment:

(1) Employee qualifications;

(2) The nature, extent and scope of the employee's work;

(3) The size and complexity of the business;

(4) Prevailing general economic conditions;

(5) The employee's compensation as a percentage of gross and net income;

(6) The employee-shareholder's compensation compared with distributions to shareholders;

(7) The employee-shareholder's compensation compared with that of non-shareholder employees or compensation paid in prior years; and

(8) Prevailing rates of compensation for comparable positions in comparable concerns.

Adopt a Strategy Now To Avoid IRS Trouble Later

To avoid IRS troubles consider implementing a well-planned strategy intended to reduce the risk that your shareholder-employee compensation will be deemed unreasonably low. Here are my recommendations:

1. Be certain your salary is commensurate with your experience and responsibilities. The greater your experience, responsibilities and effort, the greater your salary level. Therefore, if you provide substantial services to your S corporation, your salary level—consistent with prevailing industry norms—should reflect that degree of effort, responsibility and experience. If you pay yourself less than what your employees are making despite your substantial involvement in the day-to-day business affairs of your company, you are risking IRS penalties.

2. Ensure that your compensation is consistent with industry norms measured as a percentage of corporate sales or profits. You should consult industry specific publications to compare similarly sized companies within the same geographic region as yours to determine whether your compensation—measured as a percentage of sales or profits—is consistent with industry norms. Absent a

compelling business reason that might justify otherwise, your salary should increase as the company's revenues rise.

3. Your compensation compared with distribution. A large distribution coupled with a small salary will naturally invite IRS scrutiny. To reduce the risk of an IRS challenge, consider choosing a salary that at a minimum will exceed the Social Security wage base if company profits are sufficient to justify it.

4. Determine a substantiated compensation figure ahead of the new year and stick with it. Before starting the new fiscal year, consider signing a written salary agreement with the company that reflects a reasoned, substantiated salary figure for the services that you expect to render to the company. Although such an agreement is not binding on the IRS when determining whether the salary amount is reasonable, the stated figure—if it is the same as what you would pay an outside employee for rendering similar services—will likely be acceptable to the IRS.

5. Ascertain what comparable businesses pay for similar services. When determining the relative reasonableness of shareholder-employee compensation compared to industry norms, you are likely to be already familiar with several benchmarking tools readily available through the Internet, such as salary.com, monster.com or careerbuilder.com. Other tools to consult that the IRS and courts considers are Robert Half surveys, and statistics derived from the Bureau of Labor Statistics wage data.

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