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Reasonable Compensation for S Corporation Shareholder-Employees

TAX TRENDS

by Daniel Rowe, CFA
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Over the past five years, a few widely noted cases and multiple government reports have made reasonable compensation a key tax issue for S corporations. Two recent Tax Court opinions focusing on reasonable compensation for S corporation shareholder-employees provide important takeaways for owners and practitioners by addressing common issues surrounding distributions and loan repayments in the context of reasonable compensation.


Background

Secs. 3111 and 3301 require employers to pay FICA and FUTA employment taxes on wages paid to their employees. For federal employment tax purposes, an employee includes any officer of a corporation. An officer who performs more than minor services for a corporation and who receives remuneration in any form for those services is considered an employee whose wages are subject to federal employment taxes (Regs. Sec. 31.3121(d)-1(b)). When an S corporation with a sole owner (as the companies in both cases were) has a portion of its shareholder distributions reclassified as wages, there is not necessarily an unfavorable net income tax effect. The wages represent taxable income to the shareholder, but the wages and employer's payroll taxes are deductible expenses of the company. The problem lies in the payroll taxes due and, more significantly, in the relatively substantial penalties assessed by the government for failure to deposit payroll taxes and failure to file payroll returns.

Glass Blocks Unlimited

In *Glass Blocks Unlimited*, an S corporation made payments totaling \$62,488 to its sole shareholder over the two-year period at issue. The company reported a portion of the payments as dividend distributions and a portion as repayment of shareholder loans. It did not report any compensation to the shareholder, even though he worked more than 40 hours per week and performed a majority of the roles within the company. The IRS contended that all of the payments to the shareholder represented wages and assessed a payroll tax deficiency of \$9,560 plus \$3,605 in additions to tax under Sec. 6651(a)(1) and penalties under Sec. 6656. In disputing the tax and penalties, the S corporation raised two arguments. Other S corporations with similar circumstances should note the Tax Court's analyses of these arguments.

The company agreed that the sole shareholder was an employee during the years at issue. However, in these years the shareholder transferred



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funds to the company to sustain its operations during an economic downturn. The company's first contention was that a majority of the payments to the shareholder represented a nontaxable repayment of these previous loans. The IRS countered that the fund transfers were in fact capital contributions and the distributions were wages rather than repayments.

In making its decision, the Tax Court relied on the facts and circumstances to determine the true nature of the shareholder-employee's transfers to the company, noting that the S corporation had the burden of proving that they were loans. The court found that four major factors contradicted the company's position: (1) There was no written agreement or promissory note for the transferred funds; (2) the shareholder did not charge interest; (3) the company did not provide security for the loan; and (4) there was no fixed repayment schedule. The significant takeaway from this analysis is that for the transaction to be treated as a loan rather than a capital contribution, the terms of the transfer should reflect an unconditional obligation for repayment, rather than one that is entirely dependent on the company's ability to repay.

The S corporation's next argument was that reclassifying the entire distribution amount to wages would constitute unreasonable compensation. The company asserted that the shareholder-employee only worked approximately 1,040 hours per year and the value of his services did not exceed \$15.25 per hour for a reasonable annual salary of \$15,860. The court noted that a fair determination of reasonable compensation should take into account several factors. These include the shareholder-employee's role in the business, a comparison of the salary to those of similar companies for similar services, the nature and condition of the company, and potential conflicts of interest.

In this particular case, however, the Tax Court did not consider whether these other factors supported the claimed hourly value for the shareholder-employee's work. The court found that there was strong evidence that the shareholder-employee actually worked more than 2,080 hours per year. Thus, if the S corporation's \$15.25 per hour value for the shareholder-employees was considered reasonable, his annual salary for each year was at least \$31,720. This exceeded the amount actually transferred to the shareholder either year, so the court determined that the full amount of the distributions was compensation. In Fact Sheet 2008-25, the IRS stated that the amount attributable to compensation will not exceed the cash or property actually directly or indirectly received by the shareholder.

While this case did not delve deeply into the factors that an S corporation should consider in determining reasonable compensation, it does illustrate that the IRS can and will reclassify not only dividend distributions, but also purported loan repayments, as employee compensation.

Sean McAlary Ltd. Inc.

In *Sean McAlary Ltd. Inc.*, the Tax Court evaluated expert witness testimony from an IRS employee who performed a statistical analysis to determine reasonable compensation for the shareholder-employee. Despite reporting net income of \$231,454 and transferring \$240,000 to the sole shareholder, the S corporation did not report any wages or file any payroll tax returns for tax year 2006. Based on its expert witness's report, the IRS determined that of the \$240,000 received in 2006, \$100,755 represented reasonable compensation. As a result, the IRS issued the S corporation a notice of determination for an employment tax liability of \$13,693 plus \$7,667 in additional tax under Sec. 6651(a) and penalties under Sec. 6656.

The S corporation asserted that the proper amount to be reclassified as compensation should be \$24,000, which was the base amount provided for in a written compensation agreement between the shareholder-employee and the company. The court found that the agreement was not

a sound measure of the value of the shareholder-employee's services because the shareholder-employee, as well as being the sole shareholder of the S corporation, was also its sole director. In those dual roles he represented both himself and the company in writing the agreement, and thus the agreement was clearly not the product of an arm's-length negotiation. Further, the company did not even follow the agreement, as it paid no wages to the shareholder-employee, suggesting to the Tax Court that the agreement "was forgotten, ignored, or adopted as mere window dressing." Considering the company's sizable profits, and noting that the sole shareholder held all of the company's officer positions, worked 12-hour days nearly year-round, performed all of the management functions, and generated the majority of the company's revenue, the Tax Court concluded that \$24,000 was clearly unreasonably low compensation.

In its discussion of the IRS's proposed compensation amount, this case provides insight into the Service's use of metric tools, statistics, and surveys in determining reasonable compensation. The IRS expert used the California Occupational Employment Statistics Survey for 2006 to determine the median hourly wage for the primary job function of the shareholder-employee, concluding that the appropriate hourly wage was \$48.44 (\$100,755 annually). In support of this amount, which to a significant extent depended on the S corporation's location and industry, the expert used information from the Risk Management Association (RMA) Annual Statement Studies. Focusing on profit margin and percentage of compensation of officers/directors/owners to net sales, the expert cited RMA statistics to show that his proposed compensation amount was reasonable based on the financial performance and compensation rates of similar businesses in its industry.

As it had in *Glass Blocks Unlimited*, the Tax Court noted that a number of factors go into determining reasonable compensation for a shareholder-employee. The IRS focused on comparative wages and the profitability of similar businesses as the dominant factors in this case. However, the Tax Court did not simply accept the IRS's statistic-based compensation determination without question. The court noted that the sole shareholder's experience in the industry was less than that of the average employee, the company's operations were relatively modest, and a large part of the company's financial success was due to market conditions rather than the personal services or expertise of the shareholder. Based on these factors, the court determined that the IRS expert was aggressive in his determination, and reduced the shareholder-employee's reasonable compensation to \$40 per hour (\$83,200 annually).

This case demonstrates that the IRS relies not only on subjective qualities but also on concrete statistics in determining reasonable compensation of shareholder-employees. S corporations and their practitioners could benefit from periodically comparing their compensation ratios to RMA data and their salary amounts to industry-specific guides.

Reflections

The potential for sole shareholder S corporations to reduce their payroll tax liability by minimizing compensation continues to be a principal concern for the IRS and lawmakers. The immense potential loss of employment taxes has been well-documented, and, as talk of comprehensive tax reform persists, discussions continue on whether to impose self-employment tax on S corporation profits to prevent this abuse. In the meantime, such companies can expect increased scrutiny from the IRS regarding their compensation of shareholder-employees. As demonstrated in *Glass Blocks Unlimited* and *Sean McAlary Ltd.*, practitioners should be mindful of profitable S corporations that make distributions but pay no or relatively small shareholder compensation.

Even for unprofitable companies like *Glass Blocks Unlimited*, reasonable compensation may be an issue if the company transfers funds to a shareholder-employee. The considerable penalties and additions to tax,

coupled with the heightened focus on this issue, provide S corporations and their tax advisers with ample incentive to ensure that shareholder-employees are reasonably compensated.

Glass Blocks Unlimited, T.C. Memo. 2013-180; and *Sean McAlary Ltd. Inc.*, T.C. Summ. 2013-62.

EditorNotes

Daniel Rowe is a tax manager at Deemer Dana & Froehle LLP in Savannah, Ga. For more information about this column, contact Mr. Rowe at drowe@ddfcpas.com.

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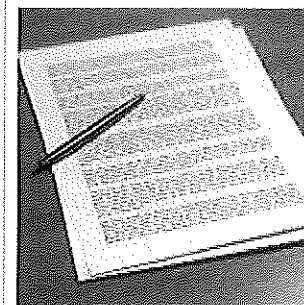
RCR Newsletter November 2013

Posted on November 8, 2013

Why S Corp Owners Require a Custom Job Profile

By Paul S. Hamann

A small business owner I know jokes that his business card should read "President and Janitor" (and everything in between). So, when my friend tries to determine his reasonable compensation figure (at his accountant's request), should he be compensated as President? Janitor? Or somewhere in between? Where in between?



That's the challenge faced by S Corp owners when trying to determine their Reasonable Compensation figure. The IRS guidelines for determining reasonable compensation specifically state that *"In addition to the shareholder-employee direct generation of gross receipts, the shareholder-employee should also be compensated for administrative work performed..."* In other words, the IRS wants the S Corp owners to pay themselves appropriately for all the duties and responsibilities they provide to their company.

Why is this question so difficult to answer? Because no two small business owners do the same things for their S Corps. Therefore, to get an accurate reasonable compensation figure an S Corp owner requires a unique, **custom job profile**. Building a custom job profile is a daunting, time consuming process, which is probably the reason most S Corp owners don't do it.

Would more small business owners make one if it were easy and quick?

In roughly 20 minutes RCRReports can build a custom job profile for a small business owner and calculate an annual salary to match.

Or build your own:

- Make a complete list of all the services you provide to your S Corp
- Apportion your time among all the services listed
- Rate your level of expertise and experience for each service performed
- Gather wage data on all the services listed and at the appropriate level of expertise
- Assemble all your research and data and calculate your Reasonable Compensation figure

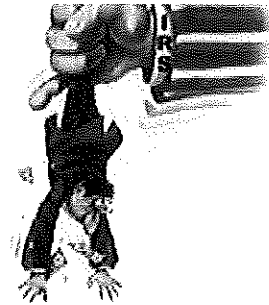
Keep in mind that determining a Reasonable Compensation figure is far from an exact science.

It is important that you research and document how you determined your Reasonable Compensation figure, and keep your explanation and all back-up documents and reference sources in a place where you can find them when the IRS comes calling. If the IRS challenges your number, you will need a detailed explanation on how you came up with your Reasonable Compensation figure.

Don't Take My Word For It

An article in the November issue of The Tax Adviser by Daniel Rowe, CPA; entitled: Reasonable Compensation for S Corporation Shareholder-Employees is a worth a few minutes of your time. Mr Rowe concludes with this advice:

“The considerable penalties and additions to tax, coupled with the heightened focus on this issue, provide S corporations and their tax advisers with ample incentive to ensure that shareholder-employees are reasonably compensated.”



Thanksgiving Occupations?

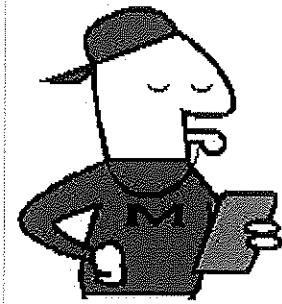
RCReports has the most complete set of wage data anywhere. We have wages for every occupation, in every location, nationwide. Our process and algorithms are so unique they are being patented.

Below are some occupations associated with Thanksgiving:

Retail Salespersons ~ Pueblo CO ~ Median pay – \$10.89/hour

Poultry Scientists ~ Pueblo CO ~ Median pay – \$30.29/hour

Football Coaches ~ Pueblo CO ~ Median pay – \$11.62/hour



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