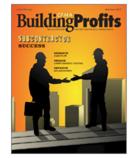

BY RICH SHAVELL

Compensation to Owners of S Corporations

Business owners commonly question how to pay or distribute money to themselves for the services they provide to their own businesses. While the IRC permits businesses to deduct "a reasonable allowance for salaries or other compensation,"[1] it is not always simple for pass-through entities.

As pass-through entities, S corporations (and partnerships) do not pay tax at the entity level; rather, their taxable income is allocated to their shareholders who are taxed individually. Let's take a look at some of the issues S corporation owners face when addressing their compensation.

S Corporation Shareholders & W-2 Wages

Shareholders of S corporations, as opposed to partners in partnerships, are viewed as investors – not active participants in the production of income presumed to "[be] engaged in carrying on the corporation's trade or business."[2] Therefore, the pass-through income of an S corporation is not subject to the self-employment tax at the individual level that applies to partnership income.[3]

Conversely, S corporations are ***required*** to pay W-2 wages to a shareholder who is actively engaged in providing services to the business. And, those W-2 wages are subject to payroll taxes such as Social Security and Medicare, collectively known as FICA taxes. These FICA taxes are paid by both the entity and the recipient (i.e., the government generally receives double the computed FICA taxes).

Under the current structure, the knowledgeable S corporation shareholder has an incentive to avoid payroll taxes due on shareholder's wages by classifying payments to the shareholder as a distribution of the entity's earnings. While distributions are an acceptable method of distributing money to S corporation shareholders (subject to several restrictions and limitations, discussed later), since 1974, the IRS has taken a firm stance against the practice of employment tax avoidance.

Accordingly, the IRS has asserted its ability to reclassify such payments as "reasonable compensation for services performed…rather than a distribution of the corporation's earnings and profits."[4] The IRS consistently maintains that an S corporation must pay its shareholder(s) a reasonable compensation before it receives distributions. This leads to the question: What is considered reasonable compensation?

Reasonable Compensation

The IRS does not provide explicit guidance or clear rules as to what constitutes reasonable compensation. Instead, we look to court decisions enumerating criteria to evaluate compensation. Although not an S corporation case, an often-cited case, *Charles Schneider & Co., Inc. v. Commissioner of Internal Revenue*, lists several factors the court considered, including:[5]

- 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 with the gross income and the net income
- The prevailing general economic conditions
- Comparison of salaries with distributions to stockholders
- The prevailing rates of compensation for comparable positions
- The salary policy of the taxpayer as to all employees
- The amount of compensation paid to the particular employee in previous years

While the criteria does not equate to a formula for determining reasonable compensation, it does make clear that an S corporation must carefully consider all of the facts and circumstances when establishing a shareholder's salary. It's important to note that the amount must be defensible.

For example, consider two construction companies with similar profitable results that are competing for work. Why does one company have an owner who takes $50,000 in annual W-2 wages while the other owner takes $350,000? Depending on the company's profitability, the first owner may be undercompensated and at-risk if audited by the IRS. At the same time, the second owner may or may not be properly compensated depending on the factors previously discussed.

In some cases, Tax Courts have focused on five[6] criteria while some circuit courts have focused on other specifics like the company's history of dividend payments, whether the employee guaranteed any corporate debt, and even corporate intent. No single factor is controlling in all situations and the corporation must be prepared to justify the wages paid.

In a case where an S corporation paid $24,000 annually and chose to pay significant dividend distributions to its sole shareholder, the IRS argued that a significant portion of the dividend distributions should be reclassified as compensation.[7] The S corporation unsuccessfully argued that the IRS could not reclassify the amounts because the entity intended to pay only the $24,000 annually as salary and the dividends "in an amount of available cash on hand after payment of compensation and other expenses of the corporation."

Evidence to support this intent was the S corporation's own meeting minutes of its shareholder and directors. The court was not swayed that the entity's intent was the sole factor to be considered. The point is that, in the event of an audit, businesses must be able to demonstrate how shareholder compensation was determined.

Consider a situation in which the S corporation's earnings are lowered for nontax purposes. If the business determines that it would reflect a year-end loss as a result of the shareholders' wages, then it could theoretically decrease shareholder wages in favor of additional distributions, since a business would not typically incur a loss in order to pay its owners. This may enable a profitable result for the entity. An ancillary effect is that the distributions at issue may exceed shareholders' basis resulting in a capital gain rather than the ordinary income from wages.

The result is threefold: net income for the entity, reduced wages and therefore reduced payroll taxes, and capital gain income available to be offset by any capital losses. And, if the IRS were to audit, the issue would be whether or not the reduced wages are unreasonably low.

Families Help Spread the Tax Impact

A strategy for many S corporations is to split income among family members to take advantage of those paying tax in lower brackets, which may lower the overall tax. For example, Tommy owns Jones Construction Company and pays tax at the highest current marginal tax rate of 37% (notwithstanding the new 20% pass-through deduction). Tommy has two adult children in the business, both of whom pay tax at a lower rate. Wages paid to the adult children rather than Tommy will face a lower tax burden, thus lowering the family's collective income taxes. Total compensation paid to each respective member of the family must be reasonable on its own. Jones Construction Company documents in its minutes that Tommy is spending less time on the daily operations of the business and this causes other employees to assume more responsibility, including Tommy's two adult children. Moreover, vacillating net income is documented to explain how cash flow may be decreased, also impacting Tommy's overall compensation.

Tax Considerations in Establishing Compensation

FICA Tax

While the amount of payroll tax due on a shareholder's compensation is not relevant to the determination of reasonableness, wages are subject to certain FICA tax limits. In 2019, the cap on wages subject to Social Security tax is $132,900. At 6.2%, the maximum Social Security tax is $8,239.80 per employee. That is the maximum withheld from the employee's compensation, but that amount is matched by the employer so the IRS receives $16,479.60.

The other portion of the FICA tax, the Medicare wages, faces no such cap. For example, an S corporation shareholder with annual W-2 wages of $325,000 would face Medicare withholdings of $4,712.50, which means that the IRS would receive $9,425 when the employer matches the Medicare tax. Moreover, note that wages in excess of $200,000 are subject to an additional Medicare withholding tax of 0.9%.[8] In this example, the extra Medicare withholdings of $1,125 ($325,000 total wages - $200,000 statutory threshold * 0.009) is not matched by the employer. The extra withholdings was added as part of the *Patient Protection and Affordable Care Act* (Affordable Care Act).

The point: On annual wages of $325,000, the FICA taxes in the aggregate for both the shareholder and the S corporation is $27,028.60 ($16,479.60 + $9,425 + $1,125) or approximately 8.32% of compensation. This amount is ***in addition to*** income taxes. From this example, it's easy to see why S corporation shareholders are conflicted and face an incentive to maintain lower annual W-2 wages.

Qualified Business Income

A new issue for S corporations is the impact of shareholder wages on the qualified business income (QBI) deduction. Increased wages reduce a corporation's qualified business income, which in turn reduces the 20% QBI deduction.[9] This is a two-sided issue: increasing compensation lowers the amount of income to which the 20% deduction is multiplied. Simultaneously, one of the limitations is that the QBI deduction is limited to 50% of total wages.[10] (For more information, see "The New Qualified Business Income: An Overview" in the September/October 2018 issue of *CFMA Building Profits*.)

For the typical contractor, particularly subcontractors, there is generally sufficient aggregate employees' wages to exceed the 50% threshold. But for others, this 50% threshold can be an issue.

Distributions

For S corporation owners, distributions paid in lieu of wages may become taxable if there is not sufficient tax basis to "take" those distributions.[11]

Consider a taxpayer with significant deferred taxable income due to the completed contract method for reporting taxable income from long-term contracts. Because earnings are deferred and not yet taxed, there may not be sufficient tax basis so distributions cannot be issued tax free to the S corporation shareholder. Here, the shareholder may choose to borrow the "distributed" money and either pay it back during the following year or at an even later date. Once the deferred income becomes taxable, the S corporation can treat the loan as a distribution. (See "Tax Implications of Debit Shareholder Loans" in the July/August 2016 issue of *CFMA Building Profits* for more information.)

To qualify as an S corporation, the entity must only have one class of stock.[12] Accordingly, shareholders cannot allocate annual pass-through income as in a partnership; distributions must be based on stock ownership. As a remedy, the entity may adjust wages for one or more shareholders to achieve the desired economic results (i.e., one shareholder receives more cash via W-2 wages in accordance with their respective actual activity). This one-class-of-stock rule is the reason tax advisors emphasize to contractors the necessity of ensuring equalizing distributions are paid either by end of the year or shortly thereafter (i.e., so the aggregate distributions for the year are in the actual stock ownership percentages). If the IRS were to later reclassify unreasonably high compensation as dividend distributions, then the result would be disproportionate distributions.

While distributions not in stock percentage according to the regulations may be an indicator of multiple classes of stock, fortunately, the reclassification by IRS does not result in failure to meet the one class of stock rule. Generally, these excess distributions from reclassifying compensation is not treated as creating second class of stock. The regulations clarify that this type of reclassification (and other limited circumstances) does not result in a second class of stock and thereby does not threaten S status for the entity.[13]

Other Non-Tax Issues

Reduced wages may have other non-tax issues. Consider the impact this may have on the contractor's various insurance premiums or how elevated net income – because of reduced owner's deductible wages – impacts financial ratios and may influence how banks underwrite loans to S corporations collectively with its shareholders.

Fringe Benefits: What Is Includable or Excludable in Wages?

Another S corporation wage issue is determining what is includable or excludable in wages. Shareholders owning 2% or less of the company's stock are generally treated the same as employees who are not owners.[14] The rules differ for shareholders who own more than 2% ("2% shareholders").

In general, 2% shareholders (and partners in partnerships) do not receive the same treatment for fringe benefits as that of their employees. Certain common fringe benefits listed below are deductible for employers, yet they are excludable from their employees' taxable wages. But these amounts are generally included in 2% shareholders' (and partners') compensation. While not an exhaustive list, the fringe benefits included in the 2% shareholders (and partners) wages are the following employer-paid amounts:

- Insurance premiums for health, dental, vision, etc.
- Contributions to health savings accounts (HSA) or medical savings accounts (MSA)
- Disability insurance premiums
- Group-term life insurance premiums
- Personal use of employer provided property and services (e.g., auto)
- Meals and lodging for the convenience of the employer

Nevertheless, 2% shareholders and partners receive the same treatment as their employees for other fringe benefits, and can exclude the following from their compensation (also not an exhaustive list):

- Retirement plan contributions
- Dependent care account contributions
- *De minimis* fringe benefits (e.g., onsite fitness facilities)

Contractors should pay close attention to these benefits, particularly health insurance premiums and HSA contributions. The IRS requires these amounts to be included in shareholders' gross wages (W-2, box 1) subject to federal income tax, but these are excluded from Social Security and Medicare wages (W-2, boxes 3 and 5) and thus, not subject to FICA taxes.[15]

In order to put the shareholder in the same position as the employees, 2% shareholders (and partners) are entitled to a self-employed health insurance deduction on their individual tax returns. This is generally limited to their net pass-through business income for the year.[16] This same mechanism applies to HSA contributions made on their behalf.[17]

For example, an employee with $100,000 of gross wages who pays $10,000 for health insurance premiums would only be taxed on $90,000 of wages, whereas a shareholder would be taxed on the full $100,000 of gross wages, but the shareholder receives an adjustment to income on their respective personal tax return for the $10,000 insurance premium.

While these are actual reporting requirements, many entities do not properly include all required items in W-2 wages such as health insurance premiums, personal use of auto, etc. One practical remedy would be having the tax preparer increase pass-through income via adjustments for nondeductible items such as the personal use of auto. Rather than including in wages these amounts are added to pass-through income and income tax is still paid on the amounts. But the requisite FICA taxes, if any, are not paid.

Moreover, because pass-through income is elevated, all income tax may not be paid because the new 20% QBI deduction may lower the effective income tax rate. Another common expedient is when the shareholder's share of health insurance premiums is deducted on the corporate return rather than included in the W-2 wages. Here, there may be variances among multiple S corporation shareholders.

Summary

CFMs have much on their plate concerning S corporation shareholder compensation, including whether shareholder compensation is as low as feasible while avoiding unreasonable compensation concerns; whether items of ancillary compensation are properly included and/or excluded from taxable compensation; and whether there is adequate documentation to support the shareholders' total wages, which includes the fringe benefits.

Most important, shareholder compensation should be routinely evaluated because what may make sense for the current year may or may not make sense in the future. ■

Endnotes

1. IRC §162(a)(1).
2. Rev. Rul. 59-221, 1959-1 CB 225.
3. Rev. Rul. 59-221, 1959-1 CB 225.
4. Rev. Rul. 74-44, 1974-1 CB 287.
5. Charles Schneider & Co., Inc. v. Comm., 34 AFTR 2d 74-5422 (500 F.2d 148), (CA8), 07/10/1974.
6. Elliotts, Inc. v. Comm., 52 AFTR 2d 83-5976, another C corporation case for which the principles apply to all corporate entities including S corporations.
7. WATSON, P.C. v. U.S., 105 AFTR 2d 2010-2624 (714 F. Supp.2d 954
8. IRC §3102(f)(1).
9. IRC §199A(a).
10. IRC §199A(b)(2)(B)(i).
11. IRC §1368(b)(2).
12. IRC §1361(b)(1)(D).
13. Reg 1.1361-1(l)(2)(vi).
14. IRC §1372(b).
15. Notice 2008-1, 2008-1 B 251, 12/31/2007.
16. Announcement 92-16, 1992-5 I.R.B. 53, 01/17/1992.
17. IRC §6051(a)(12) and Ann. 2004-2, 2004-3 IRB 322, 1/15/2004.

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