Taking Cash Out of a Business: Compensation

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How Business Owners Can Handle Cash Compensation

Compensation is key for small business owners–after all, they're in business to make money. Yet all too often small business owners "take the money and run." They simply pay out all of their profits as salary without considering other tax-saving options.

Salary payments are, of course, treated as income subject to tax at ordinary income rates. Moreover, they are subject to Social Security and Medicare taxes. By contrast, other forms of compensation may be exempt from payroll taxes and may even be eligible for favorable tax rates or entirely tax free.

In this article, we will examine alternative ways to structure cash payments from the business. In future issues, we will look at other ways for business owners to tap the company coffers, including loans and tax-favored fringe benefits.

A business owner's options for taking cash from the business depend on the way the business is structured.

Sole proprietorships: Sole proprietors have the least flexibility because all of the business' net income is reported as ordinary income on the proprietor's individual income tax return. In addition, that income is subject to Social Security and Medicare tax in the form of a self-employment ax on net earnings from self-employment [IRC Sec. 1401], albeit offset by an above-the-line deduction for one-half the self-employment tax for the year [IRC Sec. 164(f), 1402(a)(12)]. On the other hand, as we shall see in upcoming issues, sole proprietors can employ some strategies to reduce the amount of net income subject to tax.

Partnerships and LLC's: Partnerships are pass-through entities. Therefore, a partner must report his or her distributive share of partnership items on his or her tax return, whether or not the items are actually distributed to the partner. The character of each item of income, gain, loss deduction or credit included in a partner's distributive share is treated in the same manner as if the partner realized the item directly from the same source as the partnership or incurred the item in the same manner as the partnership [IRC Sec. 702(a)]. Therefore, some income items are eligible for favorable tax treatment on a partner's return. For example, capital gains passed through to a partner qualify for favorable capital gains tax rates.

Guaranteed payments made by a partnership to a partner are those determined without regard to the partnership's income. For example, guaranteed payments may include salaries or professional fees paid to the partners. These payments are generally deductible by the partnership and reported as ordinary income by the partner along with his or her distributive share of the partnership's ordinary income.

Like sole proprietors, partners are subject to self-employment tax. A partner must generally include any guaranteed payments of salary or fees as well as his or her distributive share of partnership income or loss in net earnings from self-employment [IRC Sec. 1402(a); Reg. Sec. 1.1402(a)-1(a)(2)]. However, one option is to structure the partnership as a limited partnership or limited liability company (LLC). In the case of limited partners, net earnings from self-employment include only guaranteed payments received for services performed during the year. Self-employment earnings do not include the limited partner's distributive share of partnership income [IRC Sec. 1402(a)(13).

S Corporations: Like a partnership, an S corporation is a pass-through entity. Each S corporation shareholder must report items from the S corporation on his or her own return. An S corporation must separately report to shareholders any items that could affect the tax liability of a shareholder. These separately stated items retain their character when reported on the shareholder's return. For example, if an S corporation has capital gain from the sale of a capital asset, a shareholder's pro rata share is treated as capital gain [IRC Sec. 1366(b)]. An S shareholder's pro rata share of non-separately computed income or loss is reported as ordinary income or loss on the shareholder's return.

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Salary payments to an S corporation shareholder-employee are generally deductible by the S corporation and reported as ordinary income on the shareholder's return.

Amounts received by an S corporation shareholder-employee as remuneration for services are wages for payroll tax purposes. The payments are subject to income tax withholding and both the employer's and employee's share of Social Security and Medicare taxes. However, the shareholder's portion of passed-through income is not subject to payroll taxes [Rev. Rul. 59-221].

For this reason, characterization of cash payments as dividends, rather than salary, can achieve considerable tax savings. <u>S corporation shareholder-employees shouldn't get greedy, however</u>. The IRS may reclassify dividends paid to S corporation shareholders as wages to prevent payroll tax avoidance [Rev. Rul.74-44].

> ***Example:*** Adam Anderson and Bob Brown are the sole shareholders of AB, Inc., an S corporation. Anderson and Brown each perform services for the S corporation. However, to avoid payment of payroll taxes, they draw no salaries from the corporation. Instead, AB pays them dividends equal to the amounts they would otherwise have received as reasonable compensation for their services.

The IRS ruled that the dividends were compensation for services rendered rather than a distribution of the corporation's earnings and profits. Therefore, the payments were recharacterized as wages subject to income tax withholding and payroll taxes.

C Corporations: Unlike S corporations, closely-held C corporations have traditionally avoided dividend payments to shareholders. Salary payments to C corporation shareholder-employees are deductible by the corporation as long as they are reasonable compensation for services rendered. By contrast, dividends are not deductible. Therefore, there is essentially a double tax on dividends-the income used to pay the dividend is taxed when received by the corporation and taxed again when paid out to the shareholder.

C corporation owners may want to rethink their attitude toward dividends, however. In the past, dividend income was taxed to shareholders at ordinary income rates. However, thanks to a change made by the **Jobs and Growth Tax Relief and Reconciliation Act** (JAGTRRA), dividend income is eligible for tax-favored treatment-at least for the next few years. For tax years beginning before 2009, qualified dividend income is taxed at the same rates that apply to net capital gain [IRC Sec. 1(h)(11)]. Thus, the tax rate on dividend income is generally 15% for taxpayers in the higher brackets. The tax rate is 5% for dividend income that would otherwise be taxed at a 10% or 15% regular tax rate. However, the 5% rate drops to zero for one year only in 2008 [IRC Sec. 1(h)(1)].

In the past, owners of closely held C corporations and the IRS were often at loggerheads over the owners' compensation arrangements with their corporations. The owner wanted to receive as much as possible from the corporation in the form of compensation that was deductible. On the other hand, if the compensation was in excess of what was "reasonable," the IRS would contend that the excess portion of the payments was in reality a nondeductible dividend.

In some situations, the JAGTRRA dividends change may turn this long-standing controversy on its head:

Owners may be better off *reducing or eliminating* their compensation and receiving most or all of the payments from their corporations in the form of dividends.

> **Example:** Jack O'Brien is the president and sole owner of XYZ Inc., a C corporation. He has $75,000 of profits that he can pay out as compensation or dividends.

> If the profits are paid out as dividends, XYZ will owe a corporate tax of $13,750. That leaves $61,250 to be distributed to O'Brien. At a 15% tax rate, O'Brien will net $52,062.
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> On the other hand, if the $75,000 of profits is paid out as compensation, XYZ will owe no corporate tax, but the compensation will be taxable at ordinary income rates. If O'Brien is in the 28% tax bracket, he will be left with $54,000 after income taxes. But then there are payroll taxes: $5,738 will have to be deducted from O'Brien's paychecks for Social Security and Medicare taxes and XYZ will have to pay a like amount. So, by going the compensation route, O'Brien will net only $48,262, almost $4,000 less than what he would get with a straight dividend payout.

This is an extreme example to be sure. For example, if XYZ were in a higher tax bracket, the dividend payout after taxes would be smaller. Or if O'Brien was already paid a $200,000 salary, reducing the salary and paying $100,000 out as dividends would not save much in payroll tax. That's because O'Brien and the company pay only the Medicare tax. Nonetheless, the point is all compensation packages between owners and their closely-held corporations should be reviewed to see if the owners are receiving the "best" compensation from a tax standpoint.

Bear in mind, however, that the JAGGTRRA change will certainly affect an owner's perspective on the reasonable-compensation issue, but it will also affect the IRS's. In some cases, it may to the IRS's benefit to argue that an owner is being paid an unreasonably *low* compensation and is receiving too much in the form of dividends. For example, the IRS is unlikely to allow Jack O'Brien to take his entire payout from XYZ in the form of dividends. While arguing that an owner's salary is unreasonably low would be a brand-new argument for the IRS to make in the C corporation context, the IRS has a track record on this issue when dealing with owners of S corporations.

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