S Corporations

Profits or Payday?

CPAs must be vigilant in helping their S corporation clients pay a “reasonable” salary to shareholder/employees. But what’s reasonable?

James A. Fellows and John F. Jewell

The IRS is on the lookout for S corporations that fail to pay reasonable salaries to shareholders who perform services for the corporation. The failure to pay adequate salaries—or any salary at all—to shareholder/employees (SEs) is a “red flag” for an audit. CPAs need to advise their small business clients on how to properly classify payments to shareholders so they don’t face a bigger employment tax bill down the road—with interest and penalties to boot.

MORE ART THAN SCIENCE

When corporations elect subchapter S status, the IRS sends out a notice to shareholders reminding them that SEs must be paid reasonable salaries. The notice also states that the IRS can reclassify as salaries any distributions to the shareholders. This statement has been sent out since 2005; about the time the IRS determined that it needed to curb abuse of the reasonable salary rule. Determining what a reasonable salary is may be more art than science, but the attempt must be made. Because the IRS’s goal is to collect Federal Insurance Contributions Act (FICA) tax on the salaries, one solution is to pay the maximum amount of wages subject to Old Age, Survivors and Disability Insurance (OASDI, or Social Security) tax, assuming of course this is a reasonable salary, based on the SE’s services actually rendered. The maximum salary subject to OASDI in 2007 is $97,500. (All wages, without limit, are subject to the other component of FICA, Medicare tax.) This may be appropriate for a shareholder in a full-time executive role, such as CEO or controller, assuming similarly situated executives aren’t paid significantly more in competitive businesses.

A smaller salary may be justified for a lower-ranking SE, or even an executive in a startup or a relatively small corporation. The corporation could also examine comparable wages within its industry by consulting trade publications. The salary should also consider the SE’s experience and skill, the geographic region, customer base, number of employees and time committed to the corporation. What is a reasonable salary depends on the facts of each case. No test is conclusive. It often becomes a judgment call by the IRS. Furthermore, the IRS has not published criteria to determine what a reasonable SE salary or salary range might be for various positions in a given industry. Comparable salaries from industry data are usually appropriate. The CPA can use search engines on the Internet to find just about any type of salary in any industry for given regions. In at least one instance, the Tax Court allowed statistical data from an industry and region to be used as guidance for reasonable compensation (*Wiley L. Barron v .Insp*ector *Commissioner*, TC Summary Opinion 2001-10). Barron, an Arkansas CPA, was the sole shareholder and CEO of an S corporation. In 1994, the S corporation paid him a salary of $2,000.

No salary was paid in 1995 or 1996. He received cash distributions in 1994, 1995 and 1996 of $56,352, $53,257 and $83,341, respectively. The Tax Court accepted the analysis of an IRS consultant, who estimated that reasonable compensation for a CEO of an Arkansas CPA firm of similar size for those years was $45,000, $47,500 and $49,000.

THE 60-40 APPROACH

Many CPAs advise their clients to use what is called the "60-40 rule." First, the reader should be cautioned that this is not an IRS rule. It was developed by practitioners as a simple guide for determining a reasonable salary. The IRS has not published any statement that this is a "safe harbor" for salary payments to the SE. No regulatory or judicial authority backs up the 60-40 rule. Therefore this article will use the phrase "60-40 approach" to describe the practice. Under a 60-40 approach, the split between salaries and distributions should be 60% for salaries and 40% for distributions. For example, assume that Ted is the sole SE in his profitable S corporation, working full time as its CEO. During the year he takes $70,000 in distributions from the corporation. His salary should be 60/40 X $70,000 = $105,000. This is one interpretation of the 60-40 approach, but consider the following possibility.

Suppose Ted does not take any distributions from the corporation. Instead, he "plows back" the earnings into the corporation for future needs. Does this mean he does not have to take any salary? Certainly not. If a reasonable salary is $105,000 when there are distributions, then a reasonable salary is $105,000 when there are no distributions. Also, why use a 60-40 split? Why not a 50-50 or 70-30 split? The 60-40 approach is an arbitrary rule, and CPAs should understand that. A more logical rule is to make the salary a percentage of the net business income of the S corporation before considering the salary deduction, for example, between 30% and 40%. Suppose Alice is the sole SE of her S corporation and is its full-time CEO. Before deducting her own salary, the net business income of the corporation is $100,000. A reasonable salary for her might be $40,000 in these circumstances, regardless of her distributions. Again, this is a mere suggestion. One could also base the SE salary on a percentage of gross revenue, since that indicates better than net income the extent of the SE's activity and responsibilities.

BE WARY OF INFLEXIBLE RULES

Using something like a 60-40 approach is better than nothing, in that it should prevent the S corporation from paying no salary to the SE and thus triggering an audit. But keep in mind that the base for any percentage approach is likely to change dramatically from year to year, thus creating wide salary disparities. For example, suppose Jorge is an SE who takes $50,000 in distributions from his S corporation in year 1 and $80,000 in year 2. In both years he devotes the same amount of time to the corporation. Is a year 1 reasonable salary 60/40 X $50,000 = $75,000 and a year 2 reasonable salary 60/40 X $80,000 = $120,000?

Of course not. A similar conclusion applies even if the percentage is based on net business income before the SE salary. This too could fluctuate greatly. The point is that no IRS rule insulates the S corporation from an audit on this issue. A reasonable salary depends on all the facts and circumstances in each individual case, and CPAs should be wary of becoming addicted to any hard-and-fast "rule" just because many other practitioners use it. For example, if the S corporation is a personal service corporation with one employee, the SE, then a case can be made that the entire net earnings of the corporation should be salary. At the other extreme, if the S corporation is a construction company with large amounts of capital equipment, then a good deal of the corporate earnings are a return on this capital. A reasonable salary in that case may be just 20% of the corporate earnings. Even then the CPA is reminded that this is only an educated guess not supported by any sophisticated analysis.

TAX EFFECTS OF THE RECLASSIFICATION

The reclassification of a distribution to salary decreases the S corporation's bottom-line income by an amount roughly equal to the salary, but it does not result in a dollar-for-dollar tradeoff of tax liability. As shown in the following example, the government collects more taxes when the payment is made as salary. (See also James Fellows and John Jewell, "S Corporations and Salary Payments to Shareholders," *The CPA Journal*, May 2006, pages 46–51, for a more extended discussion of this point.)

Suppose Maria is the sole shareholder and CEO of an S corporation. She does not receive any salary, but the S corporation makes $50,000 of cash distributions to her for the year. The S corporation forgoes a $50,000 salary deduction, resulting in a $50,000 increase in the corporation's bottom-line income on page 1 of Form 1120S. Because this increase passes through to Maria on her 1040, it may look like a "wash" to the untrained eye. But this ignores the fact that wages are subject to FUTA (Federal Unemployment Tax Act) and FICA taxes, while the pass through S corporation profit is not. Unlike partnerships or sole proprietorships, the net business income of S corporations that is passed through to the SE is not subject to self-employment tax. The decreased employment tax bill is what tempts the S corporation to pay the SE an unreasonably low salary. Suppose the S corporation has $90,000 of net business income on page 1 of its Form 1120S without paying any salary to Maria. By not paying Maria a salary, the S corporation avoids the following payroll taxes:

- **FICA includes 6.2% OASDI tax and 1.45% Medicare tax, paid by both the employee and employer.**

- **FUTA tax is paid by the employer on the first $7,000 in wages.**

S Corporation:
FICA Tax: $50,000 X 7.65% = $3,825
FUTA Tax: $7,000 X 6.2% = $434

Maria:
FICA Tax: $50,000 X 7.65% = $3,825

Total: $8,084

If the IRS reclassifies the $50,000 distribution to Maria as salary, it will collect $8,084 in payroll taxes. The *income tax* bill will be smaller, because the S corporation can deduct its payroll taxes of $4,259 ($3,825 + $434) in computing the bottom-line income on its 1120S. This reduces the amount passed through to Maria on her Schedule K-1 by the $50,000 reclassified salary and the $4,259 deductible payroll taxes. Instead of reporting $90,000 of business income from the S corporation, Maria reports the following:

- **Net business income on 1120S before reclassification ($90,000)**
- **Less: Salary payment ($50,000)**
- **Less: Payroll taxes ($4,259)**
- **Net business income on 1120S after reclassification ($35,741)**

Maria reports $35,741 plus her $50,000 salary, for a total of $85,741. This is $4,259less than the $90,000 she reported on her 1040 when her salary was $0. There classification of income, therefore, is not a complete wash. The IRS does collect less income tax, but this reduction is more than offset by the greater amount of payroll taxes collected. Let's assume that the applicable tax rate on this income in her1040 is 28%. She pays $1,193 ($4,259 X 0.28) less in income tax. But the Treasury is ahead when the payroll taxes are considered:

- **Total payroll taxes on the S corporation and Maria ($8,084)**
- **Reduction of income tax on Maria ($1,193)**
- **Net increase in taxes collected by the IRS ($6,891)**

AN IRS PRIORITY

This lost revenue is of great concern to the IRS. In May 2005, Pamela J. Gardiner of the office of the Treasury Inspector General for Tax Administration (TIGTA) reported that, in 2000 alone, more than 36,000 single-shareholder S corporations with profits exceeding $100,000 paid no salaries or payroll taxes. Another 40,000 with profits between $50,000 and $100,000 did not pay any salaries (*Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations*, TIGTA, Ref. No. 2005-30-080, May 20, 2005, page 3). The IRS estimated the nonpayment of salaries resulted in almost $6 billion in lost employment tax revenue. Consequently, the TIGTA report recommended to the IRS commissioner that regulations or new legislation be implemented that would require S corporation net business income to be subject to self-employment tax in the SE's tax returns if the SE owns more than 50% of the corporation's stock. The commissioner's office rejected this approach, however, and stated that it will continue to address the issue through the application of the "reasonable compensation" mandate (page 18 of the report).

OTHER DISTRIBUTIONS

If unreasonably low salaries to the SE are shown on the Form 1120S, any other distributions to the SE are suspect. Can this issue be avoided by a "disguised distribution," such as a loan to the shareholder or perhaps a distribution of property, which the shareholder can then sell for cash? Almost certainly not. The definition of a distribution to the SE includes more than direct cash payments. Loans to shareholders have been successfully reclassified by the IRS as salary [*Joly*, TC Memo 1998-361, aff'd 211 F.3d 1269 (6th Cir, 2000); G*reenlee Inc*., 661 F. Supp 642 (1985)]. Payment by the corporation of the shareholder's personal expenses also has been reclassified as salary (*Olde Raleigh Realty Corp*., TC Summary Opinion 2002-61). Thus, in our example for Maria above, the same result could occur even if the $50,000 payment were a series of corporate payments of her personal expenses for the year.

An in-kind distribution of property could also be considered a salary. IRC §§ 3121(a) and 3306(b) both define wages as "the cash value of all remuneration…paid in any medium other than cash." This prevents an SE from avoiding payroll taxes by receiving an in-kind property distribution and selling the property for cash. The fair market value of the property can be reclassified by the IRS as a salary payment.

The tax accounting effects of such a reclassification can be shown by the following example. Assume that Jack is the sole shareholder and CEO of an S corporation. The S corporation owns long-term capital gain property with an adjusted tax basis of $10,000. If the property is sold at its fair market value of $50,000 to an unrelated party, the S corporation would recognize long-term capital gain of $40,000, passing this through to Jack to report in his 1040. For the current year the corporation has net taxable income of $100,000 from its business operations. No salary is paid to Jack during the year. However, the corporation distributed the property to Jack during the year. Jack immediately sold the property for $50,000 cash to a third party. Under IRC section 301(d) Jack's tax basis in the property is its fair market value of $50,000, so he recognizes no gain on the sale.

IRC section 311(b) requires the S corporation to recognize $40,000 of long-term capital gain from the distribution. The gain is passed through to Jack, who reports this $40,000 in his tax return and pays a long term capital gains tax of $6,000 ($40,000 X 15%). Naturally, he reports the $100,000 of business income from the S corporation as well. Assuming that he is in the 28% tax bracket, he pays $28,000 of income tax on this amount.

But the IRS will likely reclassify this property distribution as a salary payment of $50,000. In that case, the corporation still recognizes $40,000 of long-term capital gain, which is passed through to Jack, so he still has a long-term capital gains tax of $6,000 to pay. However, he also has a $50,000 salary to report, with the FICA tax liability that goes with it. The corporation has a $50,000 salary deduction and must pay FICA and FUTA taxes on this amount. Both of these corporate employment tax liabilities, as well as the salary payment, are deducted in computing bottom-line income, which Jack would then report on his 1040. The end result is that the IRS collects more FICA and FUTA tax than it loses in income tax, as shown in Maria's case above.

The CPA must be very careful when working with S corporation clients to determine reasonable salaries for the SEs. If not, the IRS could view any type of distribution as a disguised salary. The CPA should advise clients to consider and document all factors used to determine salary or other compensation for an SE. CPAs should also urge clients to conduct a compensation survey or other similar study, particularly if an SE seems to be in the lower end of the compensation continuum for the corporation's size, industry, region and other factors.

CPAs conducting a survey for the express purpose of determining a reasonable salary are cautioned to suggest ranges as well as a host of factors that would alter the actual amount that would be reasonable or cause an SE to fall outside the ranges. CPAs might recommend employment agreements that embody these factors. But they should not depend on them to save the day in such circumstances, because they are not considered arm's-length agreements within a closely held corporation.