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Tax Geek Tuesday: Reasonable Compensation In The S Corporation Arena

As tax advisors, we often find ourselves at odds with our S corporation shareholder-employee clients when it comes to setting compensation. Typically, the shareholder-employee wants to minimize compensation in favor of distributions to reduce payroll taxes. We, however, are faced with a body of governing authority that establishes that the shareholder-employee cannot avoid the imposition of payroll taxes by forgoing "reasonable" compensation. Unfortunately, until recently this governing authority had offered little in terms of how to actually determine this "reasonable" compensation, leaving us with sparse guidance upon which to rely when recommending salary amounts to their clients.

Over the past few years, however, three cases have emerged that provide the direction tax advisors have been seeking. *JD & Associates, Watson,* and *McAlary* shed much needed light on the methodology the IRS and the courts employ in determining reasonable compensation in the S corporation arena, providing an analytical approach tax advisors can follow when guiding clients.

S Corporations and Employment Taxes

As pass-through entities, S corporations generally do not pay entity-level tax on their taxable income. Instead, taxable income and other attributes are allocated among the shareholders, who report the items and pay the corresponding tax on their personal income tax returns.

This S corporation flow-through income has long enjoyed an employment tax advantage over that of sole proprietorships, partnerships and LLCs. This advantage finds its genesis in Revenue Ruling 59-221, which held that a shareholder's undistributed share of S corporation income is not treated as self-employment income. In contrast, earnings attributed to a sole proprietor, general partner or many LLC members are subject to self-employment taxes.

Payroll taxes on employers, employees and the self-employed have increased dramatically. In 2014, employers will pay 6.2% of the first $117,000 of an employee's wages towards the Social Security tax, with employees paying an additional 6.2% through wage withholding. Additionally, employers and employees will split the 2.9% Medicare tax on all wages, without limitation.

Self-employed individuals will be responsible for the entire 12.4% Social Security tax – again limited to the first $117,000 of self-employment income — and the 2.9% Medicare tax on all self-employment income.

As these employment tax obligations have climbed, the advantage of operating as an S corporation has become magnified. Because S corporation income is not subject to self-employment tax, there is tremendous motivation for shareholder-employees to minimize salary in favor of distributions, which are also not subject to payroll or self-employment tax. Consider the following example:

Example 1: A owns 100% of the stock of S Co., an S corporation. A is also S Co.'s president and only employee. S Co. generates $100,000 of taxable income in 2014, before considering A's compensation. If A draws a $100,000 salary, S Co.'s taxable income will be reduced to zero. A will report $100,000 of wage income on his individual income tax return, and S Co. and A will be liable for the necessary payroll taxes. S Co. will be required to pay $7,650 (7.65% of $100,000) as its share of payroll tax, and S Co. will withhold $7,650 (7.65% of $100,000) from A's salary towards A's payroll obligation, resulting in a total payroll tax bill of $15,300.

Example 2: Alternatively, A may choose to withdraw $100,000 from S Co. as a distribution rather than a salary. S Co.'s taxable income will remain at $100,000 and will be passed through to A and reported on his individual income tax return, where it is not subject to self-employment tax. The $100,000 distribution is also not taxable to A, as it represents a return of basis. By choosing to take a $100,000 distribution rather than a $100,000 salary, S Co. and A have saved a combined $15,300 in payroll taxes.

Reasonable Compensation History: No Salary Taken

The IRS is wise to this type of compensation play. In light of these potential employment tax savings, the IRS has long challenged attempts by shareholder-employees to minimize compensation in favor of distributions. The

IRS fired its opening salvo in its attack on these perceived abuses in Revenue Ruling 74-44. In the ruling, the IRS imputed the payment of reasonable salaries to an S corporation that paid dividends but no compensation to two shareholders who provided services to the corporation.

Soon after, the Ninth Circuit Court of Appeals expanded on this line of reasoning with its decision in *Spicer*. In *Spicer*, the taxpayer was an accounting firm (SAI) established as an S corporation. SAI was owned by a CPA (Spicer), and his spouse. Spicer also served as the president, director and treasurer. As SAI's lone accountant, Spicer performed substantial services, working approximately 36 hours per week.

Spicer had an arrangement with his corporation whereby he would receive no compensation for his services; rather, as a stockholder he would withdraw his earnings as distributions. Accordingly, Spicer did not pay payroll taxes on the amounts received.

The Ninth Circuit, in analyzing the nature of the payments made to Spicer, maintained that "salary arrangements between closely held corporations and its shareholders warrant close scrutiny." In an effort to determine if the distributions truly represented remuneration for services, the Ninth Circuit established a line of analysis that would be followed repeatedly in the years to follow.

The Ninth Circuit first looked to Section 3121(d), which defines an employee for payroll tax purposes in part as..."any officer of a corporation..." Because Spicer was the president of SAI, this requirement was easily met. The Ninth Circuit then looked to Regs. Sec. 31.3121(d)-1(b), which provides an exception to employee status for some officers, but only to an officer who "...does not perform any services or performs only minor services..."

In arriving at its decision, the Ninth Circuit held that Spicer's services were substantial. As the firm's lone CPA, Spicer was the only person capable of signing tax returns, performing audits, and preparing opinion letters. The Ninth Circuit concluded that distributions paid to Spicer were properly classified as compensation subject to payroll taxes, as a corporation's sole full-time worker must be treated as an employee. Thus, *Spicer* established the principle that a shareholder/employee who provides substantial services may not take distributions in lieu of compensation.

A line of nearly identical rulings followed, with one Pennsylvania CPA at the heart of many of the decisions. In *Joseph M. Grey*, the sole shareholder of an accounting firm took no salary despite rendering significant services, opting instead to withdraw amounts as independent contractor fees. The Tax Court, utilizing the line of reasoning established in *Spicer*, held Grey to be an employee and the accounting firm liable for payroll taxes.

After its victory in *Joseph M. Grey*, the IRS smelled the proverbial blood in the water, zeroing in on the accounting firm's client list. In all, five of Mr. Grey's clients found themselves in front of the Tax Court, defending the reasonableness of their compensation. In each case, the Tax Court held the shareholders to be employees and recharacterized the distributions as compensation.

A Rare Defeat for the IRS

The heavy burden a shareholder faces in proving that services provided to a corporation are not substantial *can* be overcome. In *Davis*, 1994 WL 542927 (D. Colo. 1994), the Colorado District Court rejected the IRS's attempt to recharacterize distributions made to a shareholder of an S corporation as "arbitrary and capricious."

Davis was the president of the corporation but did not actively participate in the corporation's activities. The court, citing *Spicer*, found that the shareholder did not provide substantial services to the corporation, and met the exception from employee treatment provided for in the Section 3121 regulations. While this decision remains an anomaly in the relevant case history, it confirms that a shareholder need not draw a salary provided they only render minimal services to the corporation.

How Much Is Enough?

Unlike the cases discussed above, in *JD & Associates*, *Watson*, and *McAlary,* S corporation shareholder-employees drew both salary and distributions. As a result, the courts no longer had the burden of proving the shareholder was an employee; instead they were left to opine merely on whether the compensation paid was a reasonable reflection of the services provided. In the process, the IRS and the courts provided a much-needed roadmap for tax advisors to follow when recommending compensation amounts for S corporation shareholder-employees.

JD & Associates

In *JD & Associates*, Jeffrey Dahl (Dahl) was the sole shareholder of an accounting firm (JDA) taxed as an S corporation. Dahl was a CPA with over 20 years' experience, and he ran a very successful firm. Dahl was responsible for all off the firm's hiring decisions, paying its bills, maintaining its books and records, preparing the firm's tax returns, and preparing and reviewing tax returns for the firm's clients.

Despite this laundry list of responsibilities, Dahl drew a salary of only $19,000 in 1997, $30,000 in 1998, and $30,000 in 1999, opting instead to take distributions from the S corporation totaling $47,000 in 1997 and $50,000 in each of 1998 and 1999.

The IRS asserted that Dahl's compensation was unreasonably low, citing Dahl's responsibilities as managing partner of the firm. Engaging the services of a certified valuation engineer, the IRS made its own determination of reasonable compensation for Dahl's services.

The engineer, utilizing the Risk Management Association's ("RMA") Annual Statement Studies, compared the following financial ratios of JDA and Dahl to those of accounting firms with comparable asset levels:

1. JDA's after-tax profit as a percentage of net sales. The resulting ratio confirmed that JDA was 200%-300% more profitable than its peers.

2. Dahl's salary as a percentage of net sales. The resulting ratio confirmed that Dahl's compensation was 166%-266% less than those of his peers.

The IRS then normalized Dahl's compensation by the average officers compensation percentages found in the RMA, and determined his reasonable compensation to be $69,584 in 1997, $79,823 in 1998, and $79,711 in 1999.

In reaching its decision in favor of the IRS, the District court condensed nine factors previously used by the Eighth Circuit to determine reasonable compensation in the C corporation arena into the following three groupings:

1. Performance of the employee;

2. Salary comparisons; and

3. Company conditions.

In examining the first factor, the District court cited JDA's after-tax profit as a percentage of sales, and concluded that Dahl's performance as head of JDA was exemplary. Dahl's compensation, the District court asserted, was "not congruent to his performance."

The second factor also evidenced that Dahl's salary was unreasonable. The District court noted that Dahl took a salary barely in excess of his subordinate employees, and failed to receive a raise between 1998 and 1999 despite JDA's increase in gross receipts during those years.

Lastly, the conditions of the company dictated higher pay for Dahl. As a small enterprise with little requirements in terms of reinvestment, the District court believed there was excess capital for employee compensation, which would allow for a higher salary than that which Dahl received.

The District court concluded that Dahl's compensation was unreasonably low, resulting in a recharacterization of distributions to wages of $42,817 in 1997, $33,072 in 1998, and $35,582 in 1999 .

IRS Fact Sheet 2008-25

After the District court's decision in *JD & Associates*, the IRS issued a Fact Sheet to remind S corporations of the importance of paying reasonable compensation to its shareholder-employees. To aid shareholders in determining a reasonable salary, the IRS summarized the factors considered by the Eighth Circuit and advised shareholders to give them careful consideration in establishing their compensation. The factors are:

(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 to non-shareholder employees or paid in prior years;

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

(9) Comparison of compensation paid to a particular shareholder-employee in previous years where the corporation has a limited number of officers.

Watson v Commissioner

In 2012, the Eighth Circuit affirmed the district court's decision 2010 decision in *Watson*, 107 AFTR 2d 2011-305, (DC IA 12/12/2010), holding that an S corporation shareholder-employee (Watson) who paid himself only $24,000 in salary during 2002 and 2003 while withdrawing over $375,000 in distributions was not reasonably compensated for his services. The court further upheld the district court's determination of an annual reasonable compensation amount of $93,000, requiring Watson to recharacterize $69,000 of distributions in each year as salary.

David Watson was a CPA. He was also the sole shareholder and employee of an S corporation, which in turn was a 25% shareholder in a very successful accounting firm. Watson's share of the revenue generated by the accounting firm was allocated to his S corporation, which would then pay Watson a salary and distributions. Any amounts not paid out in salary by the corporation were reported by Watson as his share of the S corporation's income on his personal tax return, where it was not subject to payroll tax.

In 2002 and 2003, Watson set his compensation from his wholly owned corporation at a mere $24,000 per year, an amount that was less than what first-year employees at his firm were earning. In comparison, Watson received distributions of $203,651 and $175,470, respectively, in those years.

The IRS challenged Watson's compensation as being unreasonably low; arguing that by foregoing salary in favor of distributions, Watson and the S corporation were avoiding payroll tax responsibilities.

In setting Watson's salary, the IRS engaged the services of the same general engineer used *in JD & Associates*, who testified that based on the health of the accounting firm and the compensation of Watson's peers in the industry, his compensation was unreasonably low.

First, the engineer used the RMA annual statement ratios to determine that Watson's accounting firm was at least three times more profitable than comparably sized firms in the accounting field. Using data from Robert Half and a University of Iowa survey, the IRS argued that individuals in positions subordinate to Watson were paid significantly more in compensation.

To quantify the amount of reasonable compensation, the IRS turned to the Management of an Accounting Practice (MAP) survey conducted by the American Institute of Certified Public Accountants specific to the Iowa Society of CPAs. The MAP indicated that an average "director" (defined as solely an employee with no shareholder interest) in a firm the size of Watson's would realize approximately $70,000 in compensation annually. The IRS then determined that, on average, owners (defined as both a shareholder and an employee in a firm) such as Watson billed at a rate approximately 33% higher than did a director. The $70,000 in director compensation was grossed up by 33% to reflect

Watson's ownership interest, resulting in a determination of reasonable annual compensation of $93,000.

The District court, in reaching its decision in favor of the IRS, referenced Watson's 20 years of experience, advanced degree, and the hours per week he spent as one of the primary earners at a well-established firm, and concluded that any reasonable person in Watson's position at such a profitable firm would be expected to earn far more than a $24,000 salary. The court agreed with the IRS that a reasonable salary in each of 2002 and 2003 was $91,044, and correspondingly reclassified $67,044 of Watson's distributions in each of those years to compensation.

In 2012, the Eighth Circuit affirmed the holding of the District court.

McAlary

Completing the triumvirate, in August 2012 the Tax Court decided *McAlary LTD, Inc. v. Commissioner*, T.C. Summary Opinion 2013-62. McAlary was a real estate agent and the sole shareholder of an S corporation. He was also the S corporation's president, secretary, treasurer, sole director, and most productive salesperson. He managed all aspects of the corporation's operations, working 12-hour days with few days off.

McAlary set his compensation at $24,000 per year, though that was never paid. In 2006, the S corporation reported net income of $231,454, but paid no compensation to McAlary. Instead, McAlary took a distribution of $240,000.

The IRS argued that McAlary was not reasonably compensated, and once again, the Service took a scientific approach. Utilizing the same engineer employed by the IRS in *JD & Associates* and *Watson*, the IRS determined that $100,000 of the $240,000 distribution represented McAlary's "reasonable" compensation.

The engineer reached this figure by consulting the RMA study and concluding that the S corporation had a better profit margin than most in the industry. He then consulted the California Employment Statistics Survey and determined that the median wage for a real estate broker in southern California was $48.44, which when multiplied by an annual output of 2,080 hours, lead to a reasonable compensation amount of $100,000.

Interestingly, the Tax Court refused to simply accept the Service's figure. Considering the "totality of the facts and circumstances" – which included a less favorable view of the S corporation's financial operations that the picture painted by the IRS — the Court concluded that $40 per hour, or annual compensation of $83,200, was reasonable. Thus, $83,200 of the $240,000 distribution was reclassified as compensation, and McAlary was held responsible for payroll taxes on that amount.

To the best of my knowledge, this is the first case in which a shareholder-employee took no salary, and the Court didn't merely reclass all of the shareholder's distributions to compensation. As discussed below, this should provide comfort when setting a shareholder-employee's compensation.

Lessons Learned

An S corporation shareholder who provides substantial services should be treated as an employee and compensated accordingly. In computing a reasonable salary, tax advisors should take a lesson from the three cases discussed above and analyze the factors provided by the Eighth Circuit and the IRS Fact Sheet. In particular, the following factors should be given careful consideration:

Nature of the S Corporation's Business

It is no coincidence that each case cited in this discussion involves a professional services corporation, such as law, accounting, and real estate activities. It is the view of the IRS that in these businesses, profits are generated primarily by the personal efforts of the employees, and as a result, a significant portion of the profits should be paid out in compensation rather than distributions.

To the contrary, in a manufacturing or distribution business the revenue is driven less by a shareholder's personal efforts, and more by the capital and assets of the corporation. In these businesses, a lower salary can be justified for the shareholder-employees.

Employee Qualifications, Training and Experience, Duties and Responsibilities, and Time and Effort Devoted to Business

A full understanding of the nature, extent, and scope of the shareholder-employee's services is essential in determining reasonable compensation. As seen in *Davis*, a shareholder who provides limited services need not draw any salary. In addition, a reduced role for a once full-time shareholder-employee may provide justification for a decrease in salary or compensation less than industry norms. On the opposite end of the spectrum, the greater the experience, responsibilities and effort of the shareholder-employee, the larger the salary that will be required.

Compensation Compared to That of Non-shareholder Employees or Amounts Paid

in Prior Years

Here, common sense rules the day. In both *JD & Associates* and *Watson*, CPAs with significant experience and expertise were paid a smaller salary than recent college graduates. Clearly, this is not advisable.

Similarly, if a shareholder-employee has more responsibilities than the highest paid non-shareholder, the shareholder's wage should be set accordingly.

Comparisons to prior years are also relevant. If the corporation has enjoyed rising revenues but the shareholder-employee's salary has not increased, this may be an indication that compensation is unreasonably low. In addition, if the corporation recently elected "S" status and correspondingly reduced its amount of shareholder compensation, this will raise questions regarding whether the motivation behind the reduction in salary was to avoid payroll taxes.

What Comparable Businesses Pay for Similar Services

Tax advisors should review basic benchmarking tools such as monster.com, salary.com, Robert Half, and Bureau of Labor Statistics wage data to determine the relative reasonableness of the shareholder-employee's compensation when compared to industry norms.

Compensation as a Percentage of Corporate Sales or Profits.

As a vital next step, tax advisors should utilize the financial ratios published in the RMA and industry specific publications such as the MAP to determine the overall profitability of the corporation and the shareholder-employee's compensation as a percentage of sales or profits. Whenever possible, comparisons should be made to similarly sized companies within the same geographic region.

The RMA and MAP are particularly useful in that they compare a shareholder-employee's compensation to the corporation's profitability, and not to other shareholder-employees. Therefore, a CPA in Montana will not have his salary compared to a CPA in Manhattan, where the amount of reasonable compensation may well be materially different.

If the resulting ratios indicate that the S corporation is more profitable than its peers but paying less salary to the shareholder-employee, tax advisors should determine if there are any differentiating factors that would justify this lower salary, such as the shareholder's reduced role or the corporation's need to retain capital for expansion. If these factors are not present, an increase in compensation to the industry and geographic norm provided for in the publications is likely necessary.

Compensation Compared With Distribution

While large distributions coupled with a small salary may increase the likelihood of IRS scrutiny, there is no requirement that all profits be paid out as compensation. Though the District court in *Watson* recharacterized significant distributions as salary, it permitted Watson to withdraw over $110,000 as distributions in 2002 and nearly $85,000 in 2003. While it is not discussed in the decision, perhaps the court was content to recharacterize just enough distributions to ensure that Watson's compensation exceeded the Social Security wage base in place for the years at issue. In doing so, the payroll tax savings on Watson's remaining distributions amounted only to the 2.9% Medicare tax.

If a careful analysis of the factors supports compensation equal to or above the Social Security wage base, setting a shareholder's compensation below that amount likely leaves a greater likelihood of IRS scrutiny. Conversely, as the salary amounts equal or exceed the Social Security wage base, the tax savings of the salary-for-distribution trade diminishes precipitously, likely reducing the risk of an IRS challenge.

Other Considerations

Can a Shareholder Forego Both Salary and Distributions?

The IRS Fact Sheet provides "The amount of the compensation will never exceed the amount received by the shareholder either directly or indirectly. However, if cash or property…did go to the shareholder…the level of salary must be reasonable and appropriate." This language would seem to indicate that there is no requirement that compensation be paid to a shareholder-employee provided the shareholder also foregoes distributions. Even with that bit of guidance from the IRS, it is prudent advice to encourage a profitable S corporation to start making reasonable salary payments to its shareholder-employees as soon as it has the means to do so.

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