

Collette Professional Accounting

S Corporations Reasonable Compensation Requirement

Article Highlights:

- Payroll Taxes
- Corporate Officers
- Employees of a Corporation
- Reasonable Salaries
- Factors
- Flow-Through Deductions
- Wage Limitations

Unlike a C corporation, which itself pays the tax on its taxable income, an S corporation does not directly pay taxes on its income; instead, its income, losses, deductions, and credits flow through to its shareholders' individual tax returns on a pro rata basis. These distributions are not subject to self-employment (Social Security and Medicare) taxes. As a result, many S corporations ignore the requirement that each shareholder-employee must take reasonable compensation in the form of W-2 wages in exchange for services performed for the corporation. These wages are subject to Social Security and Medicare taxes (which the corporation and the employee generally split equally); the corporation is also responsible for paying the Federal Unemployment Tax (as well as any state unemployment taxes).

The Internal Revenue Code establishes that an officer of an S corporation is an employee of that corporation for Federal Unemployment Tax purposes. S corporations should not attempt to avoid paying this tax by treating their officers' compensation as distributions rather than as wages.

This has been an issue for decades; in 1974, the IRS issued a ruling stating that, when a shareholder-employee fails to take a salary, or if that salary is unreasonable, an auditor should assert that the salary is unreasonable. The officer's distributions will then be shifted to account for reasonable compensation, and he or she will be assessed the related employment taxes and penalties. At stake here are the employee's 6.2% Social Security and 1.45% Medicare payroll taxes, the S corporation's matching amounts, the Federal Unemployment Tax, and whatever state taxes happen to apply.

Who Is an Employee of the Corporation? – Generally, an officer of a corporation is considered an employee of that corporation. The fact that an officer is also a shareholder does not change the requirement that any payments made to that officer must be treated as wages. Courts have consistently held that S corporation shareholders who provide more than minor services to their corporation (and receive payment in return) are employees whose compensation is subject to federal taxes.

Tax regulations do provide an exception for officers who do not perform services or who perform only minor services. These officers are not considered employees.

What's a Reasonable Salary? – The instructions for Form 1120S ("U.S. Income Tax Return for an S Corporation") state: "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation." There are no specific guidelines in the tax code regarding the definition of reasonable compensation. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of the individual cases. These are some factors that courts have considered when determining reasonable compensation:

- The officer's training and experience
- The officer's duties and responsibilities
- The time and effort that the officer devotes to the business

- The corporation's dividend history
- The corporation's payments to non-shareholder employees
- The timing and manner of the bonuses paid to key people at the corporation
- The payments that comparable businesses have made for similar services
- The corporation's compensation agreements
- The formulas that similar corporations have used to determine compensation

The problem here, of course, is that it is easy for the IRS to simply list contributing factors that courts have used when determining reasonable compensation and leave it to each corporation to quantify these factors and determine a reasonable salary—all while retaining the ability to challenge the selected amount later if an auditor decides that the compensation is not reasonable. The IRS has a long history of examining S corporations' tax returns to ensure that reasonable compensation is being paid, particularly when a corporation pays no compensation to employee-stockholders.

199A Deduction Issue - A few years back Congress added a flow-through deduction (also referred to as the "199A deduction" after the section of the tax code that describes it). This deduction applies to S corporations (among many other business entities) and added another level of complexity to the determination of reasonable compensation.

- The wages of an S corporation's employee-stockholder are NOT treated as qualified business income (QBI) that is eligible for the individual's 199A deduction. However, the corporation deducts these wages as a business expense when it calculates the profit that passes through to the shareholder as QBI on Schedule K-1. Thus, larger wages mean less K-1 flow-through income (QBI) and thus a smaller 199A deduction (as that is equal to 20% of QBI). In these situations, S corporations tend to minimize stockholders' salaries to maximize flow-through income; this strategy increases the employee-stockholder's 199A deduction and lowers the payroll taxes for both the corporation and the employee-stockholder.
- If married taxpayers who are filing a joint return in 2022 have 1040 taxable income that exceeds \$340,100 (or \$170,050 for those with other filing statuses), the 199A deduction begins to be subject to a wage limitation. Once the 1040 taxable income for married taxpayers filing jointly exceeds \$440,100 (or \$220,050 for those with other filing statuses), the wage limitation is fully phased in. In that event, the 199A deduction becomes the lesser of the wage limitation or 20% of the QBI; if the wage limitation is zero, there is no 199A deduction. These phasing amounts are inflation adjusted annually.

The wage limitation comprises the wages that the corporation paid, including those paid to stockholders, plus the unadjusted cost of the qualified property that the corporation owned and used during the year. To be more specific, the wage limitation is the larger of

- 50% of the wages that the corporation paid to all its employees or
- 25% of the corporation's paid wages plus 2.5% of the unadjusted cost of its qualified property.

Thus, for those high-income shareholders for whom the wage limitation applies, if the corporation pays no wages and has no qualified property, the shareholder will not have a 199A deduction.

If an S corporation is a specified service trade or business, the 199A deduction phases out; for married taxpayers who are filing a joint return, it phases out at taxable incomes between \$340,100 and \$440,100 (for those with other filing statuses, it phases out between \$170,050 and \$220,050). The IRS describes specified service trades or businesses as those in the fields of health, law, accounting, actuarial science, performing arts, athletics, consulting, financial services, and brokerage services, as well as those for which reputation and/or skill are contributing factors (for more details on what constitutes a specified service trade or business, please give this office a call).

Thus, if married taxpayers who are filing jointly for 2022 have taxable income more than \$440,100 (or \$220,050 for those with other filing statuses), they receive no benefit from the wage limitation; therefore, they also tend to minimize their reasonable compensation in order to minimize their FICA taxes.

Of course, taxpayers cannot pick and choose a particular level of reasonable compensation to minimize their taxes or maximize their deductions; therein lies a trap. Taxpayers instead should consider all the factors related to reasonable compensation. However, pulling all the data together to support such a determination can be difficult and time-consuming. Some commercial firms have the necessary data and resources to properly apply the various factors mentioned in this article to determine the proper level of reasonable compensation; this can provide backup in the case of an IRS challenge.

Please give this office a call if you have questions related to reasonable compensation for S corporation shareholders or how it impacts your specific tax situation.