Reasonable Compensation Issues Remain On the IRS Radar Part II: S-Corporation Concerns

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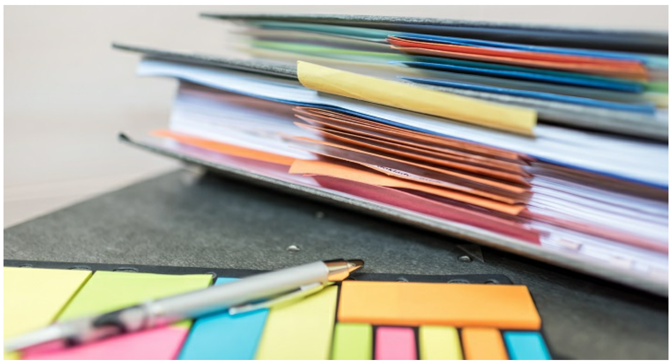

Our May 26, 2016 article, *Reasonable Compensation Issues Remain on the IRS Radar* ("Part I"), discussed how the IRS scrutinizes the reasonableness of compensation payments made to C-corporation shareholder-employees. As indicated in Part I, when a C-corporation is involved, the IRS often argues that the compensation is unreasonably high and paid to avoid the double tax on corporate profits. However, the IRS also challenges compensation payments made to S-corporation shareholder-employees. As discussed below, when an S-corporation is involved, there is a risk the IRS will take the opposite approach and argue that the compensation is unreasonably ***low***.

Income Tax Issue

Unlike a C-corporation, an S-corporation's earnings are not typically subject to double tax because its earnings are not taxed at the corporate level. Instead, the S-corporation's earnings "pass through" to the shareholders and are taxed at the shareholder level regardless of whether the earnings are actually distributed to the shareholders (for ease of reference, the distribution of earnings will be referred to in this article as "dividends"). The shareholders generally receive the dividends tax free because the shareholders have already paid tax on the earnings.

The S-corporation must pay its shareholder-employees reasonable compensation for the services the shareholder-employees actually provide to the corporation. This service-based compensation will be referred to in the article as "wages" to distinguish it from pass-through income or dividends. Although the shareholder-employees will pay income tax on the wages, the wages will reduce the amount of corporate earnings that will pass through to the shareholder-employees. So, a shareholder-employee may be indifferent from an income tax perspective as to whether the income is taxed as wages or pass-through income as illustrated in the following simple example:

> Assume S-Corporation, Inc. ("S-Corp") has two equal shareholder-employees (A and B) and has $500 of corporate earnings for the year. If S-Corp does not pay any wages to A or B, S-Corp's earnings will flow through to the shareholder-employees. A and B will each report $250 of taxable income on their individual income tax returns and generally will be eligible to receive a subsequent tax-free dividend of $250 from S-Corp. Alternatively, S-Corp could pay A and B $250 each as wages. S-Corp would receive a wage deduction of $500 which would reduce its taxable income to zero (resulting in no pass through income to the shareholders). Under this alternative, A and B will each report $250 of wage income. In either event, A and B would each report $250 of income on their individual income tax returns.

While either option appears to have the same result to A and B, the IRS won't necessarily see the two alternatives as equal.

Employment Tax Issue

Although, from an income tax perspective, A and B may initially be indifferent about how they report income from S-Corp, the classification of the income is important from an employment tax perspective. Wages are subject to employment tax. However, an S corporation's pass through income and dividends are not subject to employment tax. Therefore, to minimize employment taxes, A and B, as S-Corporation shareholders, may be inclined to receive corporate earnings in the form of dividends instead of as wages.

However, if S-Corp pays its shareholder-employee inadequate wages for the services provided to S-Corp, the IRS may try to reclassify the dividends paid to A and B as wages in order to collect employment taxes. In cases where the shareholder-employees receive dividends but fail to report *any* wages, it is relatively easy for the IRS to challenge the payment as unreasonable. However, it may be difficult to determine the portion of the payment that constitutes reasonable compensation and the portion that constitutes a dividend.

Theoretically, the IRS would take a position that is consistent with the one it took in the United States Tax Court case discussed in Part I. In that case, the IRS argued that payments were distributions (or dividends) to the C-corporation shareholder-employees to the extent the payments were funded by earnings attributable to the services of non-shareholder employees or to the use of the corporation's capital. However, in the S-corporation context, the analysis can become even more complicated. The IRS guidelines provide that S-corporations must pay reasonable compensation/wages to shareholder-employees before the corporation makes non-wage distributions/dividends. For example, assume an S-corporation shareholder-employee does not receive any wages or dividends in Year 1. The IRS may claim it is unreasonable for the shareholder-employee to receive dividends in Year 2 until the S-corporation pays reasonable wages for the services shareholder-employee provided in Years 1 and 2. As a result, the reasonable compensation/wages issue can extend over multiple years.

S-corporations have become a popular choice for small business owners. One major advantage of operating as an S-corporation is the opportunity to characterize payments to shareholder-employees as dividends to reduce employment taxes. However, the IRS may aggressively challenge the classification of the payments if the compensation for services provided, or wages, is unreasonably low. In addition to the reclassification risk, S-corporation shareholder-employees should also consider the non-tax consequences of minimizing compensation/wages. For example, reducing wages may reduce the S-corporation's ability to make contributions to a qualified retirement plan.