S Corporation Shareholder Compensation: How Much Is Enough?

S CORPORATIONS

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EXECUTIVE SUMMARY

- S corporation shareholders generally prefer dividend distributions of their S corporations' profits over compensation payments from the S corporations because the compensation payments are subject to payroll taxes and dividend distributions are not.
- To prevent S corporations and their shareholders from avoiding payroll taxes by maximizing distributions and minimizing compensation payments, the IRS requires S corporations to pay shareholders who provide substantial services reasonable compensation.
- Disputes between the IRS and taxpayers have required courts to determine on a regular basis whether an S corporation has paid reasonable compensation to its shareholder(s). Two recent district court cases provide a framework that advisers can use to determine whether the IRS and the courts will consider a shareholder's compensation reasonable.

S corporation shareholder-employees and their tax advisers often find themselves with differing goals when setting the shareholder-employee's compensation. Typically, the shareholder-employee prefers to minimize compensation in favor of distributions to reduce payroll taxes. Tax advisers, however, are faced with a body of governing authority providing 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 compute reasonable compensation, leaving tax advisers with sparse guidance upon which to rely when recommending salary amounts to their clients.

In late 2010, an Iowa district court decided *Watson*,[1] a reasonable compensation case that, together with the North Dakota District Court's 2006 decision in *JD & Associates*,[2] provides the direction tax advisers have been seeking. *Watson* and *JD & Associates* shed much-needed light on the methodology the IRS and the courts use to determine reasonable compensation in the S corporation arena, providing an analytical approach tax advisers can follow when guiding their clients.

S Corporations and Employment Taxes

As passthrough entities, S corporations generally do not pay entity-level tax on their taxable income.[3] 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.[4]

This S corporation flowthrough income has long enjoyed an employment tax advantage over that of sole proprietorships, partnerships, and LLCs. The advantage finds its genesis in Rev. Rul. 59-221,[5] 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, a general partner, or many LLC members are subject to self-employment taxes.[6]

As the need to fund Social Security and Medicare payments has risen, the employment tax burden on employers, employees, and the self-employed has increased dramatically. In 2011, employers will pay 6.2% of the first $106,800 of an employee's wages toward the Social Security tax, with employees paying an additional 4.2% through wage withholding. Employers and employees will split the 2.9% Medicare tax on all wages, without limitation.

Self-employed individuals will be responsible for the entire 10.4% Social Security tax—again limited to the first $106,800 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. Since S corporation income is not subject to self-employment tax, there is tremendous motivation for shareholder-employees to minimize their salary in favor of distributions, which are not subject to payroll or self-employment tax. Consider the following examples.

> ***Example 1****: A* owns 100% of the stock of *S* Corp., an S corporation. *A* is also *S*'s president and only employee. *S* generates $100,000 of taxable income in 2011, before considering *A*'s compensation. If *A* draws a $100,000 salary, *S*'s taxable income will be reduced to zero. *A* reports $100,000 of wage income on his individual income tax return, and *S* and *A* are liable for the necessary payroll taxes. *S* is required to pay $7,650 (7.65% of $100,000) as its share of payroll tax, and *S* withholds $5,650 (5.65% of $100,000) from *A*'s salary toward *A*'s payroll obligation, resulting in a total payroll tax bill of $13,300.

Example 2: Alternatively, *A* withdraws $100,000 from *S* as a distribution rather than a salary. *S*'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.[7] By choosing to take a $100,000 distribution rather than a $100,000 salary, *S* and *A* have saved a combined $13,300 in payroll taxes.

Reasonable Compensation History: No Salary Taken

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 opened its attack on these perceived abuses in Rev. Rul. 74-44.[8] 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.

Fifteen years later, an oft-cited decision further clarified the IRS's position on reasonable compensation. In *Radtke*,[9] the taxpayer was the sole shareholder and director of a law firm established as an S corporation. Although the taxpayer devoted all his working time to the law firm, he took no compensation for the year at issue, opting instead to withdraw $18,225 in dividends.

The IRS argued, and the district court agreed, that the dividends represented wages subject to payroll taxes, with the court adding, "where the corporation's only director had the corporation pay himself, the only significant employee, *no* salary for substantial services . . . [h]is 'dividends' functioned as remuneration for employment."

Soon after, the Ninth Circuit Court of Appeals expanded on this line of reasoning with its decision in *Spicer*.[10] In that case, the taxpayer was Spicer Accounting Inc. (SAI), an accounting firm established as an S corporation. SAI was owned by Spicer, who was a CPA, and his spouse. Spicer also served as 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 donated his services to the corporation in exchange for no compensation, and as a stockholder he withdrew his earnings as distributions. Accordingly, Spicer did not pay payroll taxes on the amounts he received.

The Ninth Circuit, in analyzing the nature of the payments made to Spicer, stated that "salary arrangements between closely held corporations and [their] shareholders warrant close scrutiny."[11] 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 Sec. 3121(d), which defines an employee for payroll tax purposes in part as "any officer of a corporation."[12] Because Spicer was the president of SAI, this requirement was easily met. The Ninth Circuit then turned its attention 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 classified properly as compensation subject to payroll taxes because "a corporation's sole full-time worker must be treated as an employee."[13]

A line of nearly identical rulings followed, with one Pennsylvania CPA at the heart of many of the decisions. In *Grey*,[14] 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, using the line of reasoning established in *Spicer*, held that the shareholder was an employee and the accounting firm was liable for payroll taxes on the independent contractor fees.

After its victory in *Grey*, the IRS zeroed in on the accounting firm's client list. In all, six of those clients found themselves in front of the Tax Court, defending the reasonableness of their compensation.[15] In each case, shareholder-employees who provided significant services to their S corporation withdrew the entire taxable income of their corporation as distributions, neglecting to take any salary. The Tax Court held that the shareholders were employees and recharacterized the distributions as compensation.

The abuses evidenced in these decisions did not go unnoticed. In 2005, the Treasury Inspector General for Tax Administration (TIGTA)[16] issued a report examining the payroll tax advantage that S corporations enjoyed over sole proprietorships. The report, which analyzed S corporation tax returns filed in 2000, revealed the following:

- Approximately 80% of all S corporations were more than 50% owned by one shareholder, giving that shareholder control in setting his or her compensation.
- Owners of single-shareholder S corporations paid themselves salaries equaling only 41.5% of the corporation's profits, down from 47.1% in 1994.
- There were 36,000 situations in which the sole owners of S corporations generating over $100,000 of income took no salaries. These corporations passed through $13.2 billion to their owners free from payroll tax.
- In total, the payroll taxes paid by single-shareholder S corporations were $5.7 billion less than the self-employment taxes that would have been imposed if the taxpayers were sole proprietors.

In 2009, a U.S. Government Accountability Office (GAO) report to the Senate Committee on Finance[17] echoed the concerns expressed in the TIGTA findings. The GAO report noted that in 2003 and 2004 combined, S corporations had underreported their shareholder compensation by $24.6 billion, with corporations with fewer than three shareholders responsible for nearly all the underreporting.

A Rare Defeat for the IRS

Although a shareholder faces a heavy burden in proving that services provided to a corporation are not substantial, it can be accomplished. For example, in *Davis*,[18] a district court held that the shareholder had proved this point and 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 its activities. The court, citing *Spicer*, found that based on the uncontroverted evidence of the shareholder, she did not provide substantial services to the corporation and met the exception from employee treatment provided for in the Sec. 3121 regulations. While this decision remains an anomaly in the relevant case history, it confirms that shareholders need not draw a salary provided they render only minimal services to the corporation.

JD & Associates and *Watson*: How Much Is Enough?

Unlike the cases discussed above, in *JD & Associates* and *Watson*, the S corporation shareholder-employees involved drew both salaries and distributions. As a result, the courts no longer had to determine that the shareholder was an employee; instead, they only had to decide whether the compensation paid was reasonable given the services provided. The opinions in these decisions give a much-needed road map for tax advisers to follow when recommending compensation amounts for S corporation shareholder-employees.

JD & Associates

In *JD & Associates*,[19] Jeffrey Dahl was the sole shareholder of JDA, an accounting firm taxed as an S corporation. Dahl was a CPA with over 20 years of experience, and he ran a very successful firm. He was responsible for making all the firm's hiring decisions, paying its bills, maintaining its books and records, preparing its 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 both 1998 and 1999.

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

The IRS expert, using a national survey of financial ratios conducted by Risk Management Association (RMA), compared the following financial ratios of JDA and Dahl to those of accounting firms with comparable asset levels:

- 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.[20]
- Dahl's salary as a percentage of net sales. The resulting ratio confirmed that Dahl's compensation was 166%–266% less than that of his peers.[21]

The IRS expert then normalized Dahl's compensation by the average officers' compensation percentages found in the RMA survey and determined his reasonable compensation to be $69,584 in 1997, $79,823 in 1998, and $79,711 in 1999.[22]

In reaching its decision in favor of the IRS, the North Dakota District Court condensed nine factors previously used by the Eighth Circuit[23] to determine reasonable compensation in the C corporation arena into the following three groupings:[24]

- Employee performance;
- Salary comparisons; and
- Company conditions.

In examining the first factor, the court cited JDA's after-tax profit as a percentage of sales and concluded that Dahl's performance as head of JDA was exemplary. Thus, the court stated that Dahl's compensation was "not congruent to his performance."[25]

The comparison of salaries also evidenced that Dahl's salary was unreasonable. The court noted that Dahl took a salary barely in excess of his subordinate employees and failed to receive a raise in 1998 and 1999 despite JDA's increase in gross receipts during those years.[26]

Finally, the conditions of the company dictated higher pay for Dahl. As a small enterprise with few requirements in terms of reinvestment, the court believed there was excess capital for employee compensation, which would allow for a higher salary than Dahl received.[27]

Having found that all three factors of its test weighed against Dahl, the court concluded that Dahl's compensation was unreasonably low and upheld the IRS's recharacterization of distributions to wages of $42,817 in 1997, $33,072 in 1998, and $35,582 in 1999.[28]

IRS Fact Sheet 2008-25

After the district court's decision in *JD & Associates*, the IRS issued a fact sheet[29] to remind S corporations of the importance of paying reasonable compensation to their shareholder-employees. To aid shareholders in determining a reasonable salary, the IRS summarized the factors considered by the courts in making this determination and advised shareholders to give them careful consideration in establishing their compensation.[30]

Watson

At the end of 2010, an Iowa district court decided *Watson*, offering another detailed look at the methodology employed by the IRS and the courts in determining reasonable compensation.

David Watson, like Jeffrey Dahl, was a CPA. He was also the sole shareholder and employee of DEWPC, an S corporation, which in turn was a 25% shareholder in LWBJ, a successful accounting firm. During 2002 and 2003, LWBJ exceeded $2 million in gross revenues. Watson typically worked 35–40 hours a week providing tax services to the firm's clients.

As the sole shareholder of DEWPC, Watson set his annual compensation at $24,000 for both 2002 and 2003. Watson received distributions from DEWPC of $203,651 and $175,470, respectively, in those years.

The IRS maintained that Watson's compensation was unreasonably low based on the services he provided to DEWPC. The IRS engaged the services of the same general engineer used in *JD & Associates* to determine an amount of reasonable compensation.

In doing so, the IRS again sought to determine the health of DEWPC and Watson's compensation relative to his peers and subordinates. The IRS expert used the RMA annual statement studies to determine that DEWPC was at least three times more profitable than comparably sized firms in the accounting field. Using data from Robert Half, a large international specialized staffing services firm, and a University of Iowa survey, the IRS expert found that individuals in positions subordinate to Watson were paid significantly more in compensation.

To quantify the amount of reasonable compensation, the IRS expert turned to the Management of an Accounting Practice (MAP) survey conducted by the AICPA 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 DEWPC would realize approximately $70,000 in compensation annually. The IRS expert 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 IRS expert grossed up the $70,000 in director compensation by 33% to reflect Watson's ownership interest, resulting in reasonable annual compensation of $93,000.[31]

The district court held in favor of the IRS. The court, citing 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, 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 both 2002 and 2003 would be $91,044; correspondingly, it reclassified $67,044 of Watson's distributions in each of those years as compensation, holding DEWPC liable for payroll taxes on the reclassified amounts.

Lessons from *JD & Associates* and *Watson*

An S corporation should treat a shareholder who provides substantial services to the S corporation as an employee and compensate him or her accordingly. In computing a reasonable salary, tax advisers should take a lesson from *JD & Associates* and *Watson* and perform an analysis using the factors provided by the Eighth Circuit[32] and the IRS Fact Sheet.[33] In particular, advisers should give several of the factors 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, or consulting firms. It is the IRS's view that in these businesses, profits are generated primarily by the personal efforts of the employees; as a result, a significant portion of the profits should be paid out in compensation rather than distributions.

To the contrary, in other types of businesses the revenue is typically driven less by a shareholder's personal efforts and more by the corporation's capital and assets. In these businesses, a lower salary for the shareholder-employees may be justified.

Employee Qualifications, 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 justify a decrease in salary or compensation to less than industry norms. Conversely, the greater the experience, responsibilities, and effort of the shareholder-employee, the larger the salary that will be required.

Compensation Compared with Nonshareholder Employees or Amounts Paid in Prior Years

Here, common sense rules. 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 nonshareholder, the shareholder's wage should logically be higher than the nonshareholder's wage.

Comparisons with 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 about whether the motivation behind the salary reduction was to avoid payroll taxes.

What Comparable Businesses Pay for Similar Services

Tax advisers should review basic benchmarking tools from sources 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 with industry norms.

Compensation as a Percentage of Corporate Sales or Profits

As another vital step in their analyses, tax advisers should use the financial ratios published in the RMA and industry-specific publications such as the MAP to determine the corporation's overall profitability and the shareholder-employee's compensation as a percentage of sales or profits. Whenever possible, advisers should make these comparisons with similarly sized companies within the same geographic region.

The RMA and the MAP are particularly useful in that they compare a shareholder-employee's compensation with the corporation's profitability and not with other shareholder-employees. Therefore, a CPA in Montana will not have his or her salary compared with 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 is paying less salary to the shareholder-employee, tax advisers 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 norms provided for in the publications likely will be necessary.

Compensation Compared with Distributions

While large distributions coupled with a small salary may increase the likelihood of IRS scrutiny, there is no requirement that an S corporation pay out all profits 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 the opinion did not discuss it, the court may have been 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.[34] 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 that wage base, the tax savings of the salary-for-distribution trade diminish greatly, and this may reduce the risk of an IRS challenge.

Can a Shareholder Forgo Both Salary and Distributions?

The IRS fact sheet provides that "[t]he 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 an S corporation pay compensation to a shareholder-employee provided that he or she also forgoes 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.

What Does the Future Hold?

S corporation reasonable compensation is a hot issue. The 2005 TIGTA report recommended imposing self-employment tax on the undistributed income of all shareholders owning more than 50% of an S corporation's stock. Similarly, the GAO report posed several alternatives for S corporation reform, including imposing self-employment tax on the undistributed income of all shareholders. Most recently, in 2010 the House of Representatives passed proposed legislation that would have subjected all undistributed income of professional service S corporations to self-employment tax.[35] The measure died in the Senate, but if a similar law were to be passed, the inherent employment tax advantage these corporations have long enjoyed would disappear.

It is likely that the limitation on the amount of Social Security wages subject to payroll tax will continue to increase, with some suggesting that Congress might remove it entirely. If this were to occur, the likelihood of abuse would only increase. Suffice it to say that *Watson* will not be the last we hear regarding S corporation reasonable compensation.

Footnotes

[1] *David E. Watson, P.C.*, 714 F. Supp. 2d 954 (S.D. Iowa 2010).

[2] *JD & Assocs., Ltd.*, 3:04-cv-59 (D.N.D. 2006).

[3] S corporations may pay corporate-level tax under Sec. 1374 (tax imposed on certain built-in gains) or Sec. 1375 (tax on excess net passive income). In those circumstances, there is motivation for an S corporation to zero out taxable income through the payment of salaries to avoid the imposition of corporate-level tax. As a result, these S corporations may find the compensation of their shareholder-employees challenged as being unreasonably high.

[4] Sec. 1366.

[5] Rev. Rul. 59-221, 1959-1 C.B. 225.

[6] Sec. 1402(a).

[7] Sec. 1368.

[8] Rev. Rul. 74-44, 1974-1 C.B. 287.

[9] *Joseph Radtke, S.C.*, 712 F. Supp. 143 (E.D. Wis. 1989).

[10] *Spicer Accounting, Inc.*, 918 F.2d 90 (9th Cir. 1990).

[11] Id.

[12] Sec. 3121(d)(1).

[13] *Spicer Accounting, Inc.,* note 10 above.

[14] *Joseph M. Grey Public Accountant, P.C.*, 119 T.C. 121 (2002).

[15] See *Veterinary Surgical Consultants, P.C.*, 117 T.C. 141 (2001); *Mike J. Graham Trucking, Inc.*, T.C. Memo. 2003-49; *Superior Proside, Inc.*, T.C. Memo. 2003-50; *Specialty Transport & Delivery Services, Inc.*, T.C. Memo. 2003-51; *Nu-Look Design, Inc.*, T.C. Memo. 2003-52, aff'd, 356 F.3d 290 (3d Cir. 2004); *Water-Pure Systems, Inc.*, T.C. Memo. 2003-53.

[16] TIGTA, *Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations* (2005-30-080) (May 2005).

[17] U.S. GAO, *Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules* (GAO-10-195) (December 2009).

[18] *Davis*, No. 93-C-1173 (D. Colo. 1994).

[19] *JD & Assocs., Ltd.*, note 2 above.

[20] Id.

[21] Id.

[22] Id.

[23] See *Charles Schneider & Co.*, 500 F.2d 148 (8th Cir. 1974). The *JD & Associates* court characterized these nine factors as: (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 nonshareholder employees or amounts 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.

[24] *JD & Assocs., Ltd.*, note 2 above.

[25] Id.

[26] Id.

[27] Id.

[28] The court agreed with the IRS expert's computation of reasonable compensation of $69,584, $79,823, and $79,711 in 1997, 1998, and 1999, respectively. However, the IRS had originally assessed these reduced amounts, which the court accepted as reasonable.

[29] FS-2008-25, *Wage Compensation for S Corporation Officers* (August 2008).

[30] The factors are as follows: (1) training and experience, (2) duties and responsibilities, (3) time and effort devoted to business, (4) dividend history, (5) payments to nonshareholder employees, (6) timing and manner of paying bonuses to key people, (7) what comparable businesses pay for similar services, (8) compensation agreements, and (9) the use of a formula to determine compensation.

[31] After reduction for nontaxable fringe benefits, reasonable compensation was held to be $91,044 in both 2002 and 2003.

[32] See note 23 above.

[33] See note 30 above.

[34] $84,900 in 2002 and $87,000 in 2003 (Publication 15-A, *Employer's Supplemental Tax Guide* 14 (rev. 2002 and rev. 2003)).

[35] American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4231, §413.

EditorNotes

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