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DANGER OF NEGLECTING REASONABLE W-2 PAYROLL FOR S CORPORATION SHAREHOLDERS

The fastest ticket to the IRS tax audit of an S Corporation "club" is neglecting reasonable compensation for shareholders. The IRS has continued increased scrutiny for S Corp payroll compliance audits in recent years. After passage of the Tax Cuts and Jobs Act (TCJA), effective for 2018, the 20% Qualified Business Income Deduction (QBID) gives the IRS greater motivation to make sure shareholder-employee wages are not too low. If the IRS audits an S Corporation and income to be compensating shareholder-workers via W-2 payroll or risk harsh IRS penalties.

The original motivation for setting an owners' W-2 wages low (or at $0) is to avoid the 15.3% FICA/Social Security tax and US and state unemployment taxes. New motivation is to maximize the amount of the QBID and lower income taxes as well. Business owners have exploited these provisions to realize substantial tax FICA savings to the tune of $1,500 or more for every $10,000 of income and now additional income tax savings ranging from 2.0 to 7.4%, depending upon their individual income tax bracket. However, utilizing distributions or loans to avoid the social security and unemployment payroll tax burdens is a very old, worn-out trick for S Corporation shareholders and the IRS now has sharper tools to identify such abuses and stronger incentives from Congress to act to pursue S Corporations that pay too little or no wages to shareholders.

Official seal of the Social Security Administration

The IRS and the courts have made it increasingly clear that distributions to an actively employed S corporation shareholder can be recharacterized as wages subject to payroll taxes if it is determined the distributions or loans are actually disguised compensation, and steep penalty assessments follow. If the IRS views payments to the shareholders as, in reality, compensation for services rendered to the corporation, they will determine payments to the shareholders are not S Corporation distributions but instead are wages subject to payroll taxes and withholding. Consequentially, the IRS "throws the book at" the overly aggressive taxpayer, assessing not only unpaid payroll taxes, but also collect penalties from the corporation for not filing its employment tax returns (Forms 940 and 941), for late deposit of the employment taxes, and also for failure to withhold income taxes on the shareholders' salary. The penalty for failure to file employment tax returns and for failure to deposit the taxes timely is 25% and 10% of the amount due, respectively. Additionally, the IRS may assess a 20% negligence penalty. These penalties are assessed not only on the unpaid payroll taxes due but also on required income-tax withholding, even if it were paid by the individual via 1040-ES estimated tax payments. Altogether, the assessment may easily exceed 33% of total corporation earnings, more than double the originally planned 15.3% "savings."

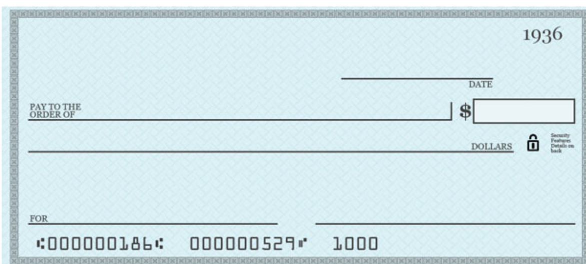
The IRS is actively looking for the following situations to initiate audits:

- Zero compensation and large distributions.
- Low salary vs. large distributions.
- Ratios that are out of line such as:
    - Sales vs. compensation.
    - Distributions vs. compensation.
    - Profit vs. compensation.

IRS agents and courts are relying on a set of nine factors, most of which were delineated over a decade ago in IRS Fact Sheet 2008-25:

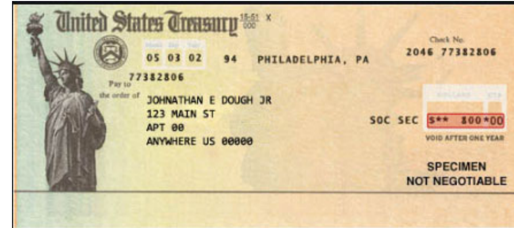
- Training and experience.
- Duties and responsibilities.
- Time and effort devoted to the business.
- Dividend history.
- Payments to non-shareholder employees.
- Timing and manner of paying bonuses to key people.
- The amount comparable businesses pay for similar services.
- Compensation agreements.
- The use of a formula to determine compensation.

Thus, it is simply not possible to make a general statement or provide a standard formula to set reasonable compensation because reasonableness must be established based on the facts and circumstances in context. However, in most situations, a range of reasonable compensation can be ascertained, and, in many situations, compensation can be fixed at the low end of a salary range that is both reasonable and supportable. The better the documentation (e.g., in the corporate minutes) and the greater the business reasons for the payments by the S corporation to its shareholders, the more likely that the compensation will withstand IRS attack.



So, generally speaking, if you set your wage amount too low you risk the wrath of the IRS, but if the amount is too high, you'll pay more Social Security, Medicare and income tax than you need. However, this traditional framework of "lower wages resulting in lower taxes" could be reversed for more profitable S Corporations that contribute to taxpayers' with higher adjusted gross income (AGI). For AGI exceeding $321,400 for a taxpayer filing jointly in 2019 (or $160,700 for other filing statuses) or $326,600 for 2020 (163,300 for other statuses), the QBID deduction may be limited by compensation made. For such higher income taxpayers, the old "rule" of lower is cheaper may not work due to this QBID limitation and more extensive calculations would be necessary.

There is one other big picture item to consider. When a shareholder is taking large distributions and minimal or no salary, s/he is likely reducing future Social Security benefits. The general rule is that the greater the wages subject to Social Security taxes (up to certain limits), the greater an individual's ultimate Social Security benefits. Thus, the strategy to minimize salary for the immediate tax reduction could substantially reduce the benefits you will receive over your lifetime.



Additionally, regarding deductible benefits for the shareholder, a zero-compensation strategy eliminates any possibility of a pre-AGI unlimited health insurance premium deduction and reduces the opportunities for retirement contributions. Shareholders are not permitted to take the full, first-page, pre-adjusted gross income deduction for company paid, company sponsored medical insurance plan premiums unless the shareholder has W-2 compensation from the S corporation and those premium payments are properly reported on the W-2. There are strict reporting requirements that must be followed for the health insurance benefit to obtain the full benefit; see our related newsletter on the topic here:
Health Insurance for Small Business Owners

Do's and Don'ts: It is EXTREMELY IMPORTANT that S Corporation owners TAKE ACTION prior to IRS contact on the matter in order to preclude the scrutiny.

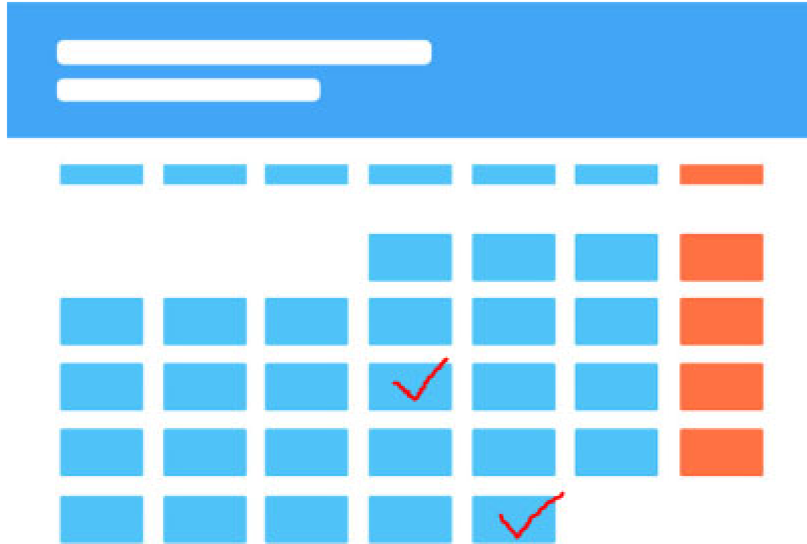
Things to Avoid:

- Paying no salary to shareholders who perform services for the S Corporation while the corporation is generating a profit since it is unreasonable to expect anyone to work for free
- Paying unreasonably low salary to shareholders
- Loans to shareholders
- Payment of shareholders' personal expenses with corporate funds
- Using 1099 to report shareholder compensation instead of W-2
- Borrowing money (via vendor payables, bank loans, or increased credit card debt) and then paying yourself a distribution or loan
- Making "distributions" more frequently than once per month
- Assuming "part-time" work for the S Corporation relieves the business of the compensation payment requirements

Things to Do:

- Pay reasonable compensation
- If shareholder loans occur, document them with a written contract, bear a reasonable rate of interest, and have strict payment terms
- Document all compensation, distribution and loan issues in corporate minutes
- Pay distributions to all shareholders on the same date in proportion to the ownership percentage

There are a few concrete steps you can take to make it more likely that the compensation you earn will be considered "reasonable," and therefore deductible by your corporation. For example, you can use the corporation's minutes to contemporaneously document the rationale for the compensation amount and if compensation is being increased in the current year to make up for earlier years in which it was too low, be sure to reflect this in the minutes. (Ideally, prior years' minutes indicate that the compensation paid in those years was at a reduced rate.) Additionally, each time a distribution payment is made it should be recorded in the corporate minutes in terms of dollar value per share. Second, you should keep all evidence you can get of what others are paying—e.g., salary offers to your executives from comparable companies, salary surveys, current classified ads, etc.—to support what you pay if you are later questioned. Third, avoid paying compensation in



direct proportion to the stock owned by the corporation's shareholders. This looks too much like a disguised dividend and may cause the IRS to recharacterize compensation in their favor. Finally, follow a good game-plan; we have options for you that will provide for flexible cash payments but still adhere to a structured wage payment. One, excellent, simple alternative is to pay yourself a wage once a month (or more as long as the intervals are regular, and the amount is consistent) on the last day of every month. Then, on the 15th of every month, cash permitting, pay yourself a "distribution" from S Corp earnings. These monthly "distributions" can vary in amounts or not be paid at all while wages should be paid at regular intervals in regular amounts. We have several techniques and cost-efficient procedures to help you simply and easily meet the IRS requirements.

Contact us to assist you with any business or individual tax matters. You may call us at 407-847-7466 or email us at taxes@sbc-cpa.com.

Revised 01/20/2020
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