HW Hot Topics Article 2018-09 S Corporations –

The Reasonable Compensation Issue

HW Hot Topics articles are brief summaries of a topic, for clients to gain a general understanding. We intend for the information to answer the "quick questions" and to advance the dialog when we provide further analysis and planning.

The Requirement

An S Corporation should pay reasonable compensation to shareholders who work in the business. An officer is presumed to provide substantial services, even without regular hours. Therefore, he or she is an employee who should be paid reasonable compensation.

Why this is Important

Some owners of S corporations take too little in compensation, and thereby avoid "FICA" (Social Security and Medicare taxes). The IRS wins every case when they find the compensation to be too little. It is a significant audit risk to pay unreasonably low compensation. Later, the S corporation owner may have another surprise, his or her minimal level of social security benefits at retirement.

Beginning in 2018, S corporation owners may have incentive to pay less compensation in order to increase the "QBID", the 20% qualified business income deduction. If compensation is reduced, business income is increased, and so is the deduction. Unfair QBID deductions may result, at significant audit risk. The penalty for substantial understatement of tax would apply, with a lower threshold.

Reasonable Compensation

The key factors to be considered are:

a. Training and experience
b. Duties and responsibilities
c. Time and effort devoted to the business
d. Dividend payments by the corporation, as evidence of cash flow that could have been used
e. Salaries of non-shareholder employees
f. Bonus programs for key personnel
g. Comparable compensation - what similar businesses pay for similar services
h. Employment agreements
i. Formulas used to determine compensation

Small Business Concerns

HW encounters smaller businesses with a significant question, 'Do I have to go into debt, in order to pay myself?' If the business cannot afford to pay, that may be a good reason not to pay compensation.

However, if the corporation has paid or will pay significant dividends, that creates the presumption that the dividends were somehow afforded and therefore the salary should have been.