Payroll and Reasonable Compensation in a Closely Held Business

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Reasonable Compensation: What is it? How is it determined?

Well..................it depends! You might think that is a vague answer and you would be correct. There is no safe harbor or bright-line test to determine whether compensation paid to a shareholder-employee of a closely held business (by business, we mean "corporation") is reasonable (and, therefore, tax deductible). The determination of "reasonable" is based on the specific facts and circumstances for a shareholder-employee and for the business.

Compensation cannot be too high and compensation cannot be too low. It must be just right in order for it to be considered reasonable for tax purposes. As you might imagine, the determination of reasonable compensation is subjective in nature and, consequently, a topic of heated debate.

This heated debate has been a favorite of the IRS over the years. Intense scrutiny of executive and shareholder-employee compensation by the IRS puts practitioners in the perfect position to proactively advise our clients on how to avoid trouble.

What do we see in our practices?

As professionals and practitioners, we are sometimes at odds with our shareholder-employee clients when it comes to determining compensation. Shareholder-employees of closely held businesses know they can "play" around with compensation. Depending on what type of corporate entity is involved (C or S Corporation), there is huge motivation by shareholder-employees to keep wages very low or very high.

Let's take a look at compensation strategies in general that apply to any business and any entity structure to set the stage for our discussion on reasonable compensation.

Compensation plans for large companies and publically traded companies are written, determined at the beginning of the year/period and tied to specific performance.

Closely held business owners' compensation plans are usually non-existent, they wait until the end of the year and compensation is usually determined by how much money is left in the bank. Doesn't that sound like some of our clients?

What do closely held business owners want the most? World peace? Name recognition? Neither of those is probably at the top of their list. So what is? Business owners want to

know how they can take as much money out of the business as possible with as little tax (payroll tax or income tax) as possible, legally, of course!

Think of a business as a Money Machine for the owners/shareholders. The business operations are the raw materials placed into the machine and Money is produced. What "type" of money is produced................that is the question?

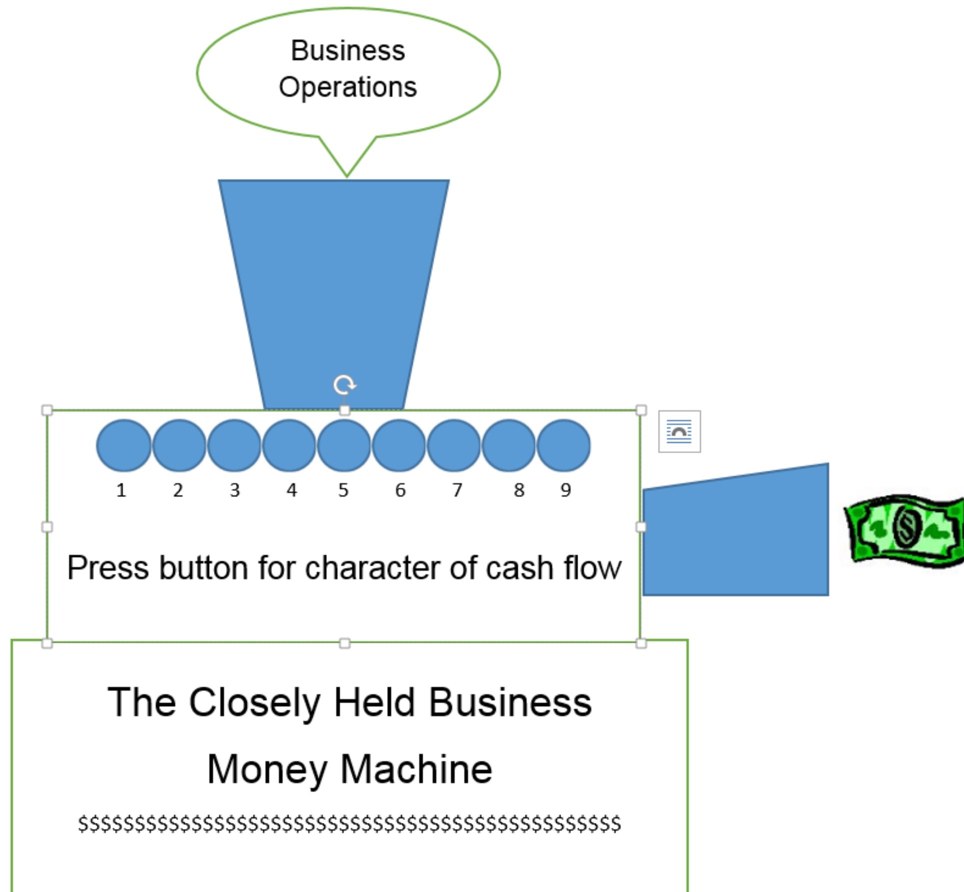
Let's take a look at the Money Machine diagram. As you can see, there are different "types" of money that can flow out of the business and into the hands of the business owner.

Let's get something clear first. Compensation for services.............what is included in that? For the closely held business, the shareholder-employer may be playing a couple of "roles" in the business. As the business owner, they are usually managing the business............ someone has to be in charge, make decisions, hire and fire employees, market and advertise, handle the corporate finances, etc. Part of their time (could be all of their time or very little of their time...........remember, it's fact specific) is spent on management. Many business owners also have to perform services other than management.............typically known as "work". This could be preparing tax returns in a tax practice or fixing a broken water pipe in a plumbing company.

Wages and compensation for services performed are subject to payroll taxes (or self-employment taxes) and income taxes. We all know that. We can't avoid it. Can we determine another type of cash flow to the business owner that is not treated as compensation and subject to the sting of payroll taxes? Of course we can, but it has to be fact specific. Not every closely held business has the ability to generate non-payroll cash flow to the business owner................but it is possible and it does exist in the real world. Sometimes we forget to think about the non-payroll cash flow options.

Depending on facts and circumstances, in addition to compensation for services, cash flow to a business owner could be in the form of:

- Rents (think real estate or equipment rental),
- Royalties (think payments for licensing agreements),
- Distribution of profits (commonly seen in S Corporations and Partnerships),
- Interest (paid on shareholder loans to the corporation),
- Dividends (subject to double taxable in C corps but still a flow of cash to owners),
- Return On capital (common in Partnerships),
- Return Of capital (can apply to corporations and partnerships) and
- Fringe benefits (there is a long list of these).



Instructions for Use: Always seek the advice of a tax/legal/compensation professional. Facts and circumstances apply. If used improperly, injury may result.

Press 1 for: Wages
Press 2 for: Rents
Press 3 for: Royalties
Press 4 for: Distribution of profits
Press 5 for: Interest
Press 6 for: Dividends
Press 7 for: Return on capital
Press 8 for: Return of capital
Press 9 for: Fringe Benefits

With the Money Machine in mind, let's take a look at a story about Hot Dog Girl.

Hot Dog Girl is a smart college graduate who can't find a job in her career of choice. During her college party days, she fondly recalls a local late night diner that served hot dogs and an idea forms in her head. Why not start a hot dog stand business? And so she does. In the first year, our Hot Dog Girl works very hard, creates special secret recipes for sauces and hot dog combinations, cooks, cleans, sells on the street.............she does it all. Her hot dogs are very popular and original. Because she's a smart college grad, Hot Dog Girl patents, trademarks and copyrights her sauce recipes and hot dog combos. By year 5, she's hired employees, managers and marketers and has 10 locations in cities up and down the west coast.

Year 1: Let's say she's a sole proprietor and makes $100,000. All subject to self-employment taxes.

Year 2: Hot Dog Girl consults a CPA for tax advice. She incorporates using IRS code section 351 and contributes in her hot dog cart and equipment and some cash in exchange for stock. She knows of no rule that says Section 351 MUST include every asset of her sole-proprietorship. She does NOT contribute the intangible assets to the corporation (remember those secret recipes and sauces she patented?), rather she executes a royalty agreement between herself and the corporation at 10 cents per dog for the use of her sauce recipes and hot dog combos. She's hired her first employees and buys three more carts. Her year 2 W-2 is $50,000 (let's assume this is reasonable as she is working full time in the business), royalty payment of $30,000 (yes..... that works out to selling 300,000 hot dogs). By the way, the royalty payment is NOT subject to payroll taxes or self-employment taxes.

Year 5: With 10 locations and regional managers, she's cut back her time working and spends 5 hours a month reviewing sales and payroll reports from her managers and manages the cash flow and company bookkeeping. The rest of her personal time is spent volunteering for her favorite charity.

C corporation: Year 5 W-2 is $10,000 (remember, she's only working 5 hours a month), royalties $270,000 (that's 2,700,000 hot dogs.............remember 10 locations!)

S Corporation: Year 5, W-2 $6,000, distribution of profit $4,000, royalties $270,000

LLC Partnership: Let's tweak the story a bit. In Year 2 instead of incorporating with only one owner, Hot Dog Girl meets Money Man who sees the potential of her business model

and invests $100,000 and has no plans to work in the business. The Money Man wants a guaranteed payment of 10% ($10,000 per year) on his capital account. Hot Dog Girl wants guaranteed payments annually of $50,000 for services to be performed and royalties at 10 cents per hot dog. Her guaranteed payments for services ARE subject to Self-Employment tax. Her guaranteed payment of royalties is NOT for services performed and NOT subject to Self-Employment tax. And obviously, Money Man's guaranteed payments for a return ON capital are NOT for services performed and thus are not subject to Self-Employment tax.

What do you need to know to keep your clients out of trouble?

Business owners are often shocked and feel insulted when an IRS auditor challenges their pay. Many business owners look to their tax professionals for advice and could put blame on their tax professional for not warning them of this potential problem area. As a professionals, we need to make sure our clients are aware of this issue. We should advise our clients to document duties performed, hours worked and key accomplishments (for bonus computations), in addition to education and experience. Other factors to consider documenting are intangibles such as personal goodwill, reputation and relationships in the industry, leadership and recruiting talents, strategic decision-making and even personal guarantee of corporate debt (there should be a "guarantor fee" paid for that!).

Code Section 162 is where the IRS starts their arguments in every reasonable compensation case. Code Section 162 says: There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including..................a reasonable allowance for salaries or other compensation for personal services actually rendered.

Treasury Regulations, Section 1.162-7 regarding compensation for personal services focuses on two specific things:

1. The Intent Test: payments for compensation must be intended to be made solely as payment for services rendered and not payment for anything OTHER than personal services.
2. The Amount Test: payments for compensation must be reasonable in amount and cannot be greater in amount than what is reasonable under the circumstances for the services actually rendered.

There are three types of business entities that attract the most attention from IRS. They are:

1. Closely held C Corporations

2. S Corporations, and
3. Not-for-profit - For this presentation, we will not discuss not-for profit entities. If you are a practitioner in this area, please be aware that these types of organizations can get into trouble for paying unreasonable compensation.

Closely Held C Corporations:

Closely held C Corporation usually get into trouble for OVER-paying shareholder-employee wages. C Corps can only deduct "reasonable" compensation paid to shareholder-employees. IRS examiners are looking for disguised dividends. Disguised dividends are corporate profits being treated as compensation. Corporate dividends are not tax deductible (double taxation!), but compensation is..........hence this is why IRS may treat a portion of compensation that it considers excessive as a dividend. This results in the C Corporation losing its tax deduction for compensation and being assessed tax, interest and penalties (ouch!).

It's very common for a shareholder-employee to be underpaid when cash flow is weak and profits are low but the shareholder-employee may be entitled to some "catch-up pay" later. Business owners in this situation should document deferral arrangements in their minutes and consider including the unpaid liability on the balance sheet (for book purposes.............not for tax purposes.............as this would generally not be allowed as a current tax deduction) to further document the deferral. Be mindful of the rules around nonqualified deferred compensation plans under Code Sec. 409A.

Have a written compensation plan in advance (not on the last day of the year!) signed by all shareholders and parties involved. Include a method or formula for determining incentive amounts and bonuses. Yearend bonuses are "hot buttons" for IRS when they appear to be based on how much money is in the bank account at the end of the year and not tied to performance.

Bonus plans can be based on incentives related to company profit goals or revenue growth. You may (should?) want to include non-shareholders and managers in the bonus plan as this shows that bonuses are not tied to ownership only.

Pay some small dividends every few years based on amount invested in the company (number of shares and dividend per share). This keeps bonuses from looking like disguised dividends. If challenged by IRS on high compensation, having a record of dividend payments makes your argument much stronger.

Be careful when the founder of the business or key employee nears retirement. If hours and time worked are significantly reduced as duties and responsibilities are transferred to others but pay remains the same, trouble could be brewing.

Be careful of loans from the corporation TO the shareholder. Auditors tend to see this as either disguised dividends or compensation that is treated as loans to avoid tax. Document any legitimate loans TO the shareholder or FROM the shareholder with a signed Note that bears a reasonable interest rate and repayment terms.

Court Cases involving C Corporations:

C Corporations have been around a very long time. Court cases involving reasonable compensation are numerous.

US Tax Court: *Pediatric Surgical Associates, P.C.*, TCM 2-001-81. This case involved a Texas professional corporation with four shareholder-employees and 2 non-shareholder-employee surgeons. The surgeons were the only income producing employees in the corporation. On audit, the Service argued that a portion of the compensation paid to the shareholder-employees was actually distributions of the profits from the services of the non-shareholder employee surgeons (disguised dividends). On the audit, the Service disallowed $600,000 of compensation in 1994 and $800,000 of compensation in 1995. On top of the disallowance, the IRS hit the taxpayer with an accuracy related Code Section 6662 penalty.

The taxpayers appealed and then went on to US Tax Court. The Court reduced the compensation disallowance to $140,000 for 1994 and $20,000 for 1995 but didn't back off from the Code Section 6662 penalty.

The taxpayers continued to fight it out in US Tax Court but did not prevail. The Court seemed narrowly focused on an analysis that each shareholder-employee's production of income less a reasonable allocation of overhead was the proper method to determine reasonable compensation for the shareholder-employees.

The Court completely ignored the fact that shareholder-employees do more than just bill their patients and produce revenue. They build goodwill, they actively participate in administration of the company, recruit and hire staff, oversee the management, finance and operations and training of professional staff.

This case is often cited in relation to professional services businesses (your practice?) that employ both shareholder-employees and non-shareholder employees to determine reasonable compensation based on billing receipts less an allocation of overhead.

In the real world, we know that closely held businesses do not run themselves and that shareholder -employees do more than just produce income. To most of us, this decision may seem unreasonable and maybe even flat out wrong, however, the case exists and we need to be aware of it.

Aries Communications, Inc. & Subs. V. Commissioner, TC Memo 2013-97: Aries Communications sold advertising spots on radio stations. From 1983 through the tax year ending August 31, 2004 (the year at issue). Mr. Aster, the president, CFO and sole shareholder was the general manager of each radio station. This guy was a real "hands on" manager who actively managed many aspects of the day-to-day operations. For the tax year audited, Mr. Astor received $6.9 million in compensation , most in the form of a bonus.

Upon exam, IRS disallowed a huge portion of the $6.9 million deduction . The Service argued that only $800,000 of the compensation was reasonable. The taxpayer's argument was that this amount included catch-up amount from the prior three years. The Tax Court disagreed with both the taxpayer and the IRS and held that approximately $2.7 million was reasonable compensation (and deductible !).

Some of the factors examined in this case are worth noting.

1. Role in the company: Mr. Astor was the key employee and played a huge role in the profitable sale of the company's assets. This weighed in his favor.
2. External Comparison to other similar companies: The company was closely held and not easily compared to similar companies. Mr. Astor was responsible for increasing the sale price of the company assets significantly . The Tax Court determined that some of his compensation was due to his efforts in increasing the value of company assets and bumped up his allowable compensation close to $2 million.
3. The character and condition of the company: The Court noted that the company was heavily in debt, had significant operati ng losses and that it had to borrow back some of the bonus paid to Mr. Astor. This didn't help Mr. Astor's case.

4. Conflict of interest: Since Mr. Astor was the sole shareholder, the Tax Court noted that he had a significant interest in the profits of the business from the asset sale and in determining his own compensation.
5. Internal consistency of compensation: There wasn't much consistency in the company's history of paying bonuses to Mr. Astor in a structured and formal way. Due to the uniqueness of the company, comparing Aires Communication to other companies was difficult. The Tax Court determined that this factor had a neutral effect on their overall determination.
6. The independent investor test: This factor considered whether an independent investor would approve a compensation package that depleted the company's assets without paying an investor some kind of return on investment. The Tax Court looked at this factor and determined that an investor could have a nearly 20% rate of return on investment.

What the Tax Court determined overall by applying many factors was that $2.7 million was reasonable of the $6.9 million originally paid and deducted.

Other interesting cases that are often cited as existing case law:

- *Multi-Pak Corp. v. Commissioner , TC Memo 2010-139*
- *Menard, Inc. v. Commissioner, 560 F.3d 620 (7th Cir. 2009), TCM 2004-207*
- *Exacto Spring Corp., 196 F3d 833 (CA-7, 1999)*
- *Mulcahy, Pauritsch, Salvador & Company, 680 F 3d 867 (CA-7, 2012), aff'g TCM 2011-74*
- *Mayson Manufacturing Co., v. Commissioner, 178 F2d 115 (6th Cir. 1949)*
- *Elliotts, Inc. v. Commissioner, 716 F 2d 1241 (9th Cir. 1983)*

The IRS and the courts look at many factors in challenging reasonable compensation. Each taxpayer has a specific set of facts and circumstances. No single factor is determinative . Factors to consider:

1. The employee's qualifications
2. The employee's role in the company
3. The nature, extend and scope of work performed by the employee
4. The size and complexity of the business
5. A comparison of salaries paid with the gross income and net income of the business
6. The prevailing general economic conditions
7. A comparison of salaries with distributions to shareholders

8. The prevailing rates of compensation for comparable positions
9. The salary policy of the taxpayer as to all employees
10. The amount of compensation paid to a particular shareholder-employee in previous years
11. Whether there is a conflict of interest regarding the negotiation of compensation (the independent investor test)
12. Whether there is internal consistency in the company's treatment of payments to employees

S Corporations:

Over the last 30 years, S Corporations have become very popular. S Corporation shareholders-employees receive compensation for services AND they get to take out non-payroll distributions of profits and not pay payroll taxes on those non-payroll distributions. This is why everyone likes S Corporations. They enjoy a self-employment tax advantage that sole-proprietors, partnerships and LLCs do not. They also enjoy only one level of tax and are not subject to the "double taxation" sting of C Corporation dividends. Because of this advantage, there is huge motivation by shareholder-employees to keep wages very low in favor of distributions.

S Corporations are audited for UNDER-paying their shareholder-employees. Many times shareholder-employees set their compensation levels unreasonably low and then increase their profit distributions. We all know compensation is subject to payroll taxes and distributions are not.

Are there reasons why an S Corporation shareholder-employee might want to OVER-pay compensation similar to a C corporation? Yes, there are. It may happen more often than you think. Four reasons why an S Corporation shareholder-employee may be motivated to pay unreasonably HIGH compensation:

1. To avoid built in gains tax
2. To maximize retirement plan contributions
3. To avoid violating the single class of stock requirement
4. To avoid the 3.8% Net Investment Income Tax for passive owners

As with C Corporations, S Corporation shareholder-employees are expected to pay reasonable compensation for their services. As mentioned above in regards to C Corporations, it's wise to have a written compensation plan for S Corporations as well.

Court Cases involving S Corporations

You can find all kinds of information on the IRS website. The IRS website states:

Several court cases support the authority of the IRS to reclassify other forms of payments to a shareholder-employee as a wage expense which are subject to employment taxes.

Authority to Reclassify	*Joly vs. Commissioner*, 211 F.3d 1269 (6th Cir., 2000)
Reinforced Employment Status of Shareholders	*Veterinary Surgical Consultants, P.C. vs. Commissioner*, 117 T.C. 141 (2001) *Joseph M. Grey Public Accountant, P.C. vs. Commissioner*, 119 T.C. 121 (2002)
Reasonable Reimbursement for Services Performed	*David E. Watson, PC vs. U.S., 668 F.3d 1008 (8th Cir. 2012)*

It's a well-documented fact that the IRS's first blow to S Corporation owners' low (or no) compensation strategies was Revenue Ruling 74-44. The ruling asserts that the IRS may re-characterize dividend distributions to a shareholder-employee when such distributions are received in lieu of wages.

Soon after Revenue Ruling 74-44, various courts, including the Tax Court, the Third Circuit, the Seventh Circuit and the Ninth Circuit expanded on this concept and held that where a shareholder-employee received no salary, a portion, if not all, of such shareholder -employee's dividend distribution was clearly compensation for services rendered.

Keep this in mind....................absent some transfer of property from the corporation to the shareholder (cash, assets, or other property) nobody cares if the shareholder works for FREE. With no transfer of property (a paycheck, distribution of profits or loan repayment) there is nothing the IRS could reclassify. The IRS can't create compensation out of thin air. The IRS CAN reclassify some transfer of property as compensation. This really depends upon the facts and the amount of services performed.

There are numerous IRS court cases involving S Corporations. Let's take a look at some.

In *Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990)* , Spicer Accounting, Inc. was owned by a CPA (Spicer) and his spouse. Spicer was the only accountant, he performed substantially all of the services and was the only person who could sign tax returns. Of course, he determined that no salary was needed and gave himself distributions only instead.

While analyzing the facts of the case, the Ninth Circuit maintained that "salary arrangements between closely held corporations and its shareholders warrant close

scrutiny." The Circuit established a line of analysis that would be followed repeatedly in the years following this case.

The Ninth Circuit looked at Section 3121(d), which defines an employee for payroll tax purposes in part as "any officer of a corporation." Looking a bit deeper into Section 3121 at 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." Clearly Spicer easily met the "any officer of a corporation" definition but he certainly did NOT meet the "does not perform any services" definition.

This line of reasoning lead to additional court cases.

Joseph M. Grey Public Accountant, P.C. vs. Commissioner, 119 T.C. 121 (2002). In the case of Joseph M. Grey, the Tax Court used this line of reasoning and got Grey on the same issue as Spicer – rendering significant services without taking a salary and withdrawing distributions only. By the way, Mr. Grey was a CPA, too.

Poor Mr. Grey..........once the Tax Court got him, they looked at his clients and got five of them, too!

The IRS doesn't always win! Facts and circumstances matter. While S Corporation shareholders face a heavy burden in proving that services provided to a corporation are NOT substantial or significant, the case can be made to prove it.

In *Davis, 1994 WL 542927 (D. Colo. 1994)* the IRS did not prevail against the taxpayer. Davis was the president of a corporation but he did not actively participate in the daily corporate operations. In Colorado District Court, it was argued, while citing the Spicer case, that Davis did NOT provide substantial services and met the definition of Section 31.3121(d)-1(b). He performed only minor services to the corporation which didn't rise to the need to draw a salary.

We know the IRS went after and won on cases where no salary was paid and there were substantial services. What about cases where the shareholder-employee DID in fact take salary and distributions? There are several cases and this is where the word Reasonable comes into play in regards to Compensation.

I hate to say this, but CPAs seem to be the drivers of case law for reasonable compensation. The Watson case is another shining example of "creative accounting".

David E. Watson, PC vs. U.S., 668 F.3d 1008 (8th Cir. 2012): David Watson was a CPA with approximately 20 years of experience. He was the sole shareholder and employee of an S Corporation. His S Corporation was a 25% partner in a very successful accounting firm in Des Moines. While Watson performed work solely on behalf of the Des Moines accounting firm, it was his S Corporation that employed him. In each of 2002 and 2003,

the S Corporation distributed approximately $24,000 to him as compensation. In addition to this salary, Watson, through his S Corporation, received distributions from the Des Moines accounting firm equal to $203,651 in 2002 and $175,470 in 2003.

IRS challenged Watson on his compensation and distribution strategy and argued that his compensation was too low and that Watson was avoiding payroll taxes. The Court looked at Watson's 20 years of accounting experience, the 35 to 45 hours per week that he devoted to the Des Moines accounting firm, the firm's annual gross earnings of approximately $2 million in 2002 and $3 million in 2003 and the fact that a $24,000 annual salary was unreasonably low when compared to similarly situated accountants. Ultimately, the Court held and affirmed that $91,044 per year was reasonable given Watson's services rendered to the Des Moines accounting firm.

In a very similar case, JD & Associates, 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. He was very successful and rendered significant services to the corporation by 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.

Surprisingly (ha!) despite all these responsibilities, his salary was only $19,000 in 1997, $30,000 in 1998, and $30,000 in 1999. Distributions were $47,000 in 1997 and $50,000 in both 1998 and 1999.

The IRS asserted that Dahl's compensation was unreasonably low based on the services rendered. The IRS used an expert to determine reasonable compensation for Dahl's services. The expert compared JD & Associates to similar firms and ran ratio comparisons for after tax profits as a percentage of net sales and salary as a percentage of net sales. These ratios helped IRS determine that Dahl's compensation was not congruent to his performance, he barely made more than his employees, failed to increase his compensation when profit years were higher and that there was room in the company's cash flow for more wages for Dahl.

The IRS kindly recharacterized distributions to wages of $42,817 in 1997, $33,072 in 1998, and $35,582 in 1999.

It's not always CPAs who get into trouble. This next case is about a real estate agent.

In *McAlary LTD, Inc. v. Commission, T.C. Summary Opinion 2013-62*, McAlary was a real estate agent and sole shareholder of an S Corporation. He worked 12 hours a day and did it all. He set his compensation at $24,000 per year but never paid it. In 2006, the S Corporation had $231,454 of net income and McAlary took $240,000 in distributions and no wages. The IRS challenged this (of course!). Using an expert, the IRS determined his salary should be $100,000. The Tax Court thought otherwise and determined

compensation should be $83,200. Thus, $83,200 of the $240,000 distribution was reclassified as wages.

Surprisingly in the McAlary case, the court didn't reclassify ALL of the distributions.

In the next case, the shareholder-employee wasn't so lucky.

In *Glass Blocks Unlimited, T.C. Memo. 2013-180*, Glass Blocks Unlimited was an S corporation with Frederick Blodgett as its president and sole shareholder. Blodgett worked full-time for the corporation selling glass blocks for the real estate market. There were no other full-time employees. With the downturn in the real estate market, the business experienced financial difficulties, and Blodgett transferred funds to the company in order to cover operating expenses and other costs. In 2007, he transferred $30,000 from his family trust. His fiancé at the time contributed $15,000 in 2007, and an additional $10,000 in 2008.

Blodgett took no salary in 2007 or 2008 nor did he have any other employment in those years. However, he did take distributions of $30,844 in 2007, and $31,644 in 2008. For 2007, the corporation reported gross receipts of $832,579 and net income of $877; for 2008, gross receipts were $701,388 and net income was $8,950. The corporation also reported the repayment of $29,132 of loans from shareholders in 2007 and $8,391 in 2008. Loans from shareholders were shown on the balance sheet on the return.

In an employment tax audit, the IRS determined that Blodgett should be classified as an employee and that the distributions ($30,844 for 2007 and $31,644 in 2008) were wages.

The court noted that for employment tax purposes, wages are defined as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash" (with certain exceptions). The critical fact is whether a payment actually received is remuneration for employment. The court noted Blodgett was the taxpayer's only officer and performed substantially all of the work necessary to operate the business, and his services generated all of the corporation's income.

The S Corporation argued that a portion of the distributions represented repayment of loans between the corporation and Blodgett and should not be considered wages. According to Blodgett, transfers to the corporation of $45,000 in 2007 and $10,000 in 2008 were loans. The IRS argued they were contributions to capital. The court considered the factors when evaluating whether amounts transferred to a closely held corporation are loans or capital contributions, and sided with the IRS in finding they were not bona fide loans (this could have been avoided with an executed Promissory Note and repayments with interest).

The taxpayer also argued that $15,680 would be reasonable compensation based on a 20-hour week and a salary of $15.25 per hour. The court found Blodgett's involvement in the business was more substantial, and that he worked more than 20 hours a week. Finally, even at $15.25 per hour, the salaries of $30,844 and $31,644 were reasonable for a full-time employee. The court allowed the IRS's computation of the employment tax, as well as penalties for failure to deposit taxes and failure to file employment tax returns. Ouch!

Why was Blodgett treated differently than McAlary? In Blodgett, the court allowed the full amount of the distributions to be classified as salaries, despite the fact that the business was only nominally profitable at the time. In McAlary, the business was very profitable but the courts did not reclassify all of the distributions.

So now what? How much is enough when it comes to reasonable compensation?

Clearly, reporting no salary is asking for trouble if substantial services are rendered. But how much of a salary should a shareholder-employee take? That's not an easy question. There are several factors to consider and for each shareholder-employee, those factors will vary.

I have a three rules of thumb when handling S Corporations compensation; 1) typically, if all of the cash flow out is treated as wages, the IRS loves it, 2) if wages are greater than the distributions, probably no IRS audit and finally 3) if wages are less than a distribution or loan, trouble is brewing without supporting facts and circumstances.

The IRS came out with a Fact Sheet 2008-25 (see: http://www.irs.gov/uac/Wage-Compensation-for-S-Corporation-Officers) to provide some factors considered by the courts in determining reasonable compensation. This is very similar to the factors used in court cases involving C Corporations.

1. Training, experience, duties and responsibilities
2. Time and effort devoted to the business
3. Dividend history
4. Comparison of employee-shareholder's compensation with distributions to shareholders.
5. Compensation to non-shareholder employees compared to employee-shareholder
6. Timing and manner of paying bonuses to key people
7. What comparable businesses pay for similar services
8. Compensation agreements
9. The use of a formula to determine compensation (percentage of gross and net income)
10. The size and complexity of the business
11. Prevailing general economic conditions

What isn't listed in the IRS Fact Sheet 2008-25 is what are the non-income generating services performed by the shareholder-employee? Think in terms of management services, marketing, staff training, recruiting and overall administrative services. Businesses do not run themselves. These non-income generating services performed by shareholder-employees matter and should be considered when determining reasonable compensation.

Reasonable Compensation Conclusions

FACT AND CIRCUMSTANCES MATTER! Many factors apply in determining reasonable compensation. As practitioners and advisors to business owners, we can help them evaluate the risks associated with compensation-related planning.

Payroll issues in a closely held businesses

No matter how big or small your tax practice might be or how big or small your business clients might be, a thorough understanding of federal and state payroll issues is a must.

Our clients look to us for advice on reasonable compensation but they also look to us for advice on staying compliant with the filing of 50+ quarterly and annual payroll tax forms. Between the federal and state taxing agencies, there are plenty of rules and forms and frustrations.

Many closely held businesses struggle with payroll issues in general. Some of the most common payroll mistakes that companies make are:

1. Misclassifying employees as independent contractors
2. Failure to issue Forms 1099 for MISC, INT, DIV, etc.
3. Failure to timely pay payroll tax deposits
4. Failure to timely file quarterly Form 941, annual Forms 940, W-3/W-2
5. Failure to reimburse business expenses under the Accountable Plan rules
6. Failure to include taxable fringe benefits in employees' income
7. Failure to file required state payroll tax forms (L&I, Employment Security)

This isn't, by any means, a complete list, just the most common.

What about those pesky State of Washington payroll tax forms? Employment Security and Labor & Industry have specific guidelines for filing, paying, independent contractor determination and much more.

For L&I, go to: http://www.lni.wa.gov/FormPub/Detail.asp?DocID=2134 and

www.independentcontractor.lni.wa.gov

For Employment Security, go to: https://esd.wa.gov/employer -taxes/independent -contractors

Corporate officers can elect to be covered by Labor & Industries. The default is that corporate officers/owners are NOT covered. So, if your shareholder-employee wants coverage, this election must be made.

Go to: http://www.lni.wa.gov/FormPub/Detail.asp?DocID=24 02

Consider having shareholder-employees obtain separate third party disability insurance rather than Labor & Industries coverage. A person is more likely to get injured while having fun at home then at work. Disability insurance can make a huge difference if there is a non- work related injury.

Employment Security also has a voluntary election for corporate officer coverage. For information on this, go to: https://esd.wa.gov/Search?q= faq+corporate+officers

Special Payroll Issues for S Corporations Owners: S Corp Medical

If your practice is anything like mine, the majority of your business clients are S Corporations. Along with reasonable compensation issues, we have special treatment of medical insurance premiums for 2% or more shareholders. With the advent of the Affordable Care Act, knowing the particulars about how health insurance is treated with S Corporations is a must.

A useful link on the IRS website is: http://www.irs.gov/Businesses/Small -Businesses -&-Self-Employed/S -Corporation -Compensation -and-Medical -Insurance -Issues

Below is a section from this link relating to health insurance. It's quite thorough and really does a good job of explaining the rules.

Treating Medical Insurance Premiums as Wages
Health and accident insurance premiums paid on behalf of a greater than 2-percent S corporation shareholder-employee are deductible by the S corporation and reportable as wages on the shareholder-employee's Form W-2, subject to income tax withholding. However, these additional wages are not subject to Social Security, or Medicare (FICA), or Unemployment (FUTA) taxes if the payments of premiums are made to or on behalf of an employee under a plan or system that makes provision for all or a class of employees (or employees and their dependents). Therefore, the additional compensation is included in the shareholder-employee's Box 1 (Wages) of Form W-2, Wage and Tax Statement, but is not included in Boxes 3 and 5 of Form W-2.

A 2-percent shareholder-employee is eligible for an above-the-line deduction in arriving at Adjusted Gross Income (AGI) for amounts paid during the year for medical care premiums

if the medical care coverage was established by the S corporation and the shareholder met the other self-employed medical insurance deduction requirements. If, however, the shareholder or the shareholder's spouse was eligible to participate in any subsidized health care plan, then the shareholder is not entitled to the above-the-line deduction. IRC § 162(l).

Health Insurance Purchased in Name of Shareholder
The insurance laws in some states do not allow a corporation to purchase group health insurance when the corporation only has one employee. Therefore, if the shareholder was the sole corporate employee, the shareholder had to purchase his health insurance in his own name.

The IRS issued Notice 2008-1, which ruled that under certain situations the shareholder would be allowed an above-the-line deduction even if the health insurance policy was purchased in the name of the shareholder. Notice 2008-1 provided four examples, including three examples in which the shareholder purchased the health insurance and one in which the S corporation purchased the health insurance.
Notice 2008-1 states that if the shareholder purchased the health insurance in his own name and paid for it with his own funds, the shareholder would not be allowed an above-the-line deduction. On the other hand, if the shareholder purchased the health insurance in his own name but the S corporation either directly paid for the health insurance or reimbursed the shareholder for the health insurance and also included the premium payment in the shareholder's W-2, the shareholder would be allowed an above-the-line deduction.

The bottom line is that in order for a shareholder to claim an above-the-line deduction, the health insurance premiums must ultimately be paid by the S corporation and must be reported as taxable compensation in the shareholder's W-2.

ACA Impact
The Affordable Care Act (ACA) did not change the above rules regarding the federal tax treatment of health and accident premiums paid for a 2% shareholder.
However, for tax years after 2013, the ACA imposes penalties on the S corporation if the S corporation offers a health plan that fails to comply with certain market reform provisions, which may include plans under which the S corporation reimburses employees for the cost of individual health insurance premiums. The potential excise tax is $100 per day, per employee, per violation.

Among the ACA market reform provisions is a requirement that a group health plan must not impose annual limits on essential health benefits. In Notice 2013-54, the IRS indicated that a health plan under which an employer reimburses employees for the cost of individual health insurance premiums (referred to as an "employer payment plan") will generally be treated as failing this requirement because the employer payment plan is treated as imposing a limit up to the cost of the individual policy premium.

The excise tax for failure to satisfy the ACA market reforms generally will not be imposed on an S corporation in the following two situations:

1. *The S corporation provides medical benefits under a health plan that satisfies the ACA market reform requirements(for example, a group health plan that does not provide for reimbursement of individual policy premiums); or*

2. *No more than one active employee participates in the employer payment plan under which the S corporation reimburses the cost of individual policy premiums.*

The ACA market reform provisions do not apply to plans that cover fewer than two participants who are active employees. IRC § 9831(a)(2).

Notice 2015-17 Transition Relief
On February 18, 2015, the IRS issued Notice 2015-17, which provides transition relief for S corporations that sponsor employer payment plans covering 2-percent shareholders. Notice 2015-17 provides that, unless and until additional guidance provides otherwise, S corporations and shareholders may continue to rely on Notice 2008-1 with regard to the tax treatment of 2-percent shareholder-employee and their healthcare arrangements for all federal income and employment tax purposes. The Department of Labor and the IRS are contemplating publication of additional guidance on the application of the market reforms to a 2-percent shareholder-employee healthcare arrangement.

Until such guidance is issued, and in any event through the end of 2015, the excise tax under IRC § 4980D will not be asserted for any failure to satisfy the market reforms by a 2-percent shareholder-employee healthcare arrangement.

Further, unless and until additional guidance provides otherwise, an S corporation with a 2-percent shareholder-employee healthcare arrangement will not be required to file IRS Form 8928 (regarding failures to satisfy requirements for group health plans under chapter 100 of the Code, including the market reforms) solely as a result of having a 2-percent shareholder-employee healthcare arrangement.

Note: To the extent that a 2-percent shareholder is allowed both the above-the-line deduction and the premium tax credit, Rev. Proc. 2014-41 provides guidance on computing the deduction and the credit.

Fewer Than Two Participants Who Are Current Employees Exception
As discussed above, market reforms do not apply to plans that cover fewer than two active employees. Notice 2015-17 explains that if the S corporation employs more than one employee, where the additional employee is a spouse or child of the shareholder and all employees are covered under a reimbursement arrangement with family coverage under the same plan, the arrangement would be considered to only cover one employee and would not be subject to the market reforms. As such, an S corporation with only

family employees covered by the same plan may continue to reimburse for a family plan and fall under the "fewer than two participants who are current employees" exception to the market reforms.

With respect to coverage of employees who are not 2-percent shareholders, Notice 2015-17 explains that if an S corporation maintains more than one reimbursement arrangement covering both 2-percent shareholder-employees and non-2-percent shareholder-employees, the arrangements would be considered a group health plan and would not be exempted under the "fewer than two participants who are current employees" exception to the market reforms. Such a plan would generally fail to satisfy the ACA market reform requirements and thus may trigger the excise tax under IRC § 4980D with respect to the non-2-percent shareholder employees. However, Q&A-1 of Notice 2015-17 provides that no penalties under § 4980D will be assessed under such an arrangement until at least June 30, 2015.

Fringe Benefits

What are fringe benefits? An employee fringe benefit is a form of pay OTHER than money for the performance of services by the employee. Any fringe benefit provided to an employee is taxable income for that person UNLESS the tax law specifically excludes it from taxation. In other words, it's taxable unless it's not!

There is a long list of fringe benefits that are tax-free and do not need to be included in the recipients' compensation. They include:

1. Health insurance (don't forget...........special rules apply to >2% S Corp owners)
2. Accident insurance
3. Health Savings Accounts
4. Dependent care assistance
5. Educational assistance
6. Group term life insurance coverage
7. Qualified employee benefits plans, such as profit-sharing plans
8. Employee stock options
9. Lodging on your business premises
10. Moving expense reimbursements
11. Achievement awards
12. Commuting benefits
13. Employee discounts on goods and services
14. De minimis (low cost) fringe benefits such as low value holiday gifts, event tickets, coffee and soft drinks
15. Cafeteria plans that allow employees to choose among benefits
16. Working condition fringe benefits – that is property and services provided to an employee so that the employee can perform his/her job

IRS Publication 15-B – Employer's Tax Guide to Fringe Benefits at:
http://www.irs.gov/pub/irs -pdf/p15b.pdf

Several of these non-taxable fringe benefits do require formal documentation and must be fairly applied to all employees and cannot be discriminatory.

Some of the more common TAXABLE fringe benefits are:

1. Excessive mileage reimbursements (exceed the IRS standard mileage rate)
2. Moving expenses for an employee move of less than 50 miles
3. Clothing (think street wear and not uniforms)
4. Excessive education reimbursements
5. Awards and prizes
6. Expense reimbursements without adequate accounting
7. Working condition fringes that are not for 100% business use. The value of any personal use of a working condition fringe must be included in the employee's compensation .