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IRS continues to challenge compensation paid to S corporation shareholder-employees that is not considered reasonable

S corporations should strive to ensure that their shareholder-employees are receiving compensation that is commensurate with the services being rendered

In brief

Over the years, the IRS has increased its focus on the issue of inadequate compensation by emphasizing through revenue rulings, form instructions, fact sheets, and other guidance that S corporations cannot avoid paying federal employment taxes by characterizing the income earned by shareholder-employees as distributions instead of compensation for services. Furthermore, as evidenced by recent case law, the IRS continues to be willing to go to court over the issue when the amount of compensation paid to shareholder-employees is not considered 'reasonable' in light of the surrounding facts and circumstances. Accordingly, S corporations should strive to ensure that their shareholder-employees are receiving compensation that is commensurate with the services being rendered. S corporations and their shareholder-employees should also make sure they understand the tests that may be used by the IRS and the courts in evaluating the reasonableness of such compensation.

Background

While an S corporation shareholder-employee's salary potentially is subject to federal (and state) employment taxes, the shareholder-employee's distributive share of income, as well as any distribution received, is not subject to employment taxes. Therefore, when extracting cash from the company, a shareholder-employee can minimize his or her tax burden by taking distributions from the S corporation's

Accumulated Adjustments Account (AAA) in lieu of a salary. However, a shareholder-employee of an S corporation must receive compensation that is commensurate with the services being rendered. In other words, compensation received by a shareholder-employee must be reasonable.

The lack of a bright-line rule is part of what makes the reasonable compensation issue so difficult to navigate, meaning it is inherently a facts and circumstances analysis. What makes the issue peculiar in the S corporation context is that the taxpayer is in the unusual position of arguing that the amount of compensation should be relatively low. In the C corporation context, the taxpayer usually is arguing that the amount of compensation should be relatively high, thus minimizing the effect of double taxation.

Early IRS guidance

In Rev. Rul. 74-44, 1974-1 C.B. 287, the IRS held that two S corporation shareholder-employees who performed services for the S corporation could not avoid employment taxes by taking distributions from the S corporation in lieu of—and in the same amount that they otherwise would have received—reasonable compensation for their services. Accordingly, the IRS held that such distributions were wages subject to employment taxes under both the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA).

Subsequent IRS guidance

Some years ago, the IRS added a cautionary statement to the instructions to Form 1120S, *US Income Tax Return for an S corporation*, relating to reasonable compensation: “Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation.”

In 2008, the IRS issued a Fact Sheet (FS-2008-25), further emphasizing that S corporation officers are included in the definition of 'employee' for employment tax purposes and that employment tax obligations cannot be avoided where services are rendered. This point was repeated multiple times within the Fact Sheet:

> Corporate officers are specifically included within the definition of employee for FICA (Federal Insurance Contributions Act), FUTA (Federal Unemployment Tax Act) and federal income tax withholding under the Internal Revenue Code. When corporate officers perform services for the corporation, and receive or are entitled to receive payments, their compensation is generally considered wages. Subchapter S corporations should treat payments for services to officers as wages and not as distributions of cash and property or loans to shareholders.
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> The Internal Revenue Code establishes that any officer of a corporation, including S corporations, is an employee of the corporation for federal employment tax purposes. S corporations should not attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages.
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> Generally, an officer of a corporation is an employee of the corporation. The fact that an officer is also a shareholder does not change the requirement that payments to the corporate officer be treated as wages. Courts have consistently held that S corporation officer/shareholders who provide more than minor services to their corporation and receive or are entitled to receive payment are employees whose compensation is subject to federal employment taxes.

The foregoing guidance is designed to discourage S corporations from taking tax return positions that are based largely on the definition of 'wages' or 'employee,' which the IRS generally considers to be inappropriate. More to the point, the guidance is designed to encourage S corporations to pay their shareholder-employees reasonable compensation for services rendered.

More recent developments

On the judicial front, there continues to be disputes regarding the issue of reasonable compensation. Recently, in *Watson, P.C. v. Unites States*, 668 F.3d 1008 (8th Cir. 2012), the court held that the IRS's recharacterization of S corporation distributions as wages subject to employment taxes was not improper, despite the taxpayer's purported intent to pay its shareholder-employee only a nominal salary. This case should serve as a reminder to taxpayers that the IRS still is willing to go to court over the issue of reasonable compensation.

On the legislative front, a few bills designed (at least in part) to mitigate the S corporation reasonable compensation issue have recently surfaced, like the Narrowing Exceptions for Withholding Taxes Act of 2012 (H.R. 3840) and the more recent Stop the Student Loan Interest Rate Hike Act of 2012 (S. 2343). In general, these bills would require shareholder-employees of certain S corporations to take into account their distributive share of income or loss when determining net earnings from self-employment. While none of these bills has been signed into law, the mere fact that they were proposed may indicate a greater willingness on the part of the government to resolve the reasonable compensation issue through legislation, as opposed to letting it resolve itself through the normal administrative and judicial processes, especially if additional revenue is needed to pay for high-priority tax cuts or other expenditures.

Further complicating matters is President Obama's new 0.9% Medicare surtax on single individuals with wages over $200,000 (married couples with wages over $250,000), which goes into effect beginning in 2013. While it is difficult to say for certain how this surtax will impact the reasonable compensation issue, it could end up indirectly providing S corporations with a greater incentive to minimize the amount of compensation paid to shareholder-employees.

What some S corporations are doing

Some of the approaches that S corporations are taking in establishing the amount of compensation to be paid to shareholder-employees include:

- paying an arbitrary salary
- paying a salary equal to living expenses
- paying a salary equal to the Social Security wage base cap

Unfortunately, these approaches all have potential flaws. For example, a salary that is arbitrary or based on the shareholder-employee's living expenses is not completely objective. Likewise, a salary that is based on the Social Security wage base cap may result in Medicare tax liabilities if the amount of the salary is not considered reasonable. Regardless of the approach, the compensation amount initially selected should be tested against a more objective standard that aids in measuring reasonableness.

Evaluating the reasonableness of compensation strategies

One way to evaluate the reasonableness of S corporation compensation strategies is to employ the multi-factor approach described in case law related to excessive compensation in the C corporation context. The multi-factor approach is derived mainly from *Mayson Manufacturing, Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949), and *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983). A summary of these factors is set forth below.

The *Mayson* factors

In *Mayson*, the Sixth Circuit identified nine factors to consider in determining whether compensation is reasonable, with no single factor being determinative. These factors are:

(1) employee qualifications

(2) nature, extent, and scope of the employee's work

(3) size and complexities of the business

(4) comparison of salaries paid with the gross income and net income of the business

(5) prevailing general economic conditions

(6) comparison of salaries with distributions to stockholders

(7) prevailing rates of compensation for comparable positions in compensation concerns

(8) salary policy of the taxpayer as to all employees

(9) amount of compensation paid to the particular employee in previous years.

The *Elliotts* factors

In *Elliotts*, the Ninth Circuit identified five factors to consider in determining whether compensation is reasonable. These factors are:

(1) the employee's role in the company

(2) external comparison to other businesses

(3) the character and condition of the business

(4) whether there is a conflict of interest regarding the negotiation of compensation

(5) whether there is internal consistency in the company's treatment of payments to employees.

In addition to compressing the nine *Mayson* factors into five factors, *Elliotts* introduced the concept of a hypothetical 'independent investor' in determining whether compensation is reasonable (see also *Exacto Spring Corp., v. Commissioner*, 196 F.3d 833 (7th Cir. 1999)). This approach seeks to determine whether an independent investor would be willing to compensate the employees as they were compensated, taking into account the nature and the quality of the services, as well as the effect of those services on the investor's return on investment.

Where does this leave S corporations and their shareholder-employees?

It is clear that when shareholder-employees render services to their S corporation, they should receive some amount of compensation. In turn, the S corporation should pay employment taxes associated with that compensation, as applicable. Once the S corporation decides to compensate its shareholder-employees, it needs to determine how much compensation is enough—i.e., what amount of compensation is 'reasonable.'

As noted above, the courts historically have focused on one of a few different multi-factor tests in determining whether compensation is considered reasonable. Despite their inherent limitations, these tests can be valuable tools. In particular, they can provide an S corporation and its shareholder-employees with an understanding of how the IRS might begin to approach the issue of reasonable compensation upon audit. More importantly, they can help an S corporation and its shareholder-employees evaluate the risks associated with compensation-related strategies being considered.

Lastly, S corporations should keep an eye out for future legislation that would require shareholder-employees of S corporations to take into account their distributive share of income or loss when determining net earnings from self-employment, especially if broad-based tax reform is undertaken in the near term.

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