

Reasonable Compensation for Shareholder-Employees of S Corps

Presented by RCReports, Inc.

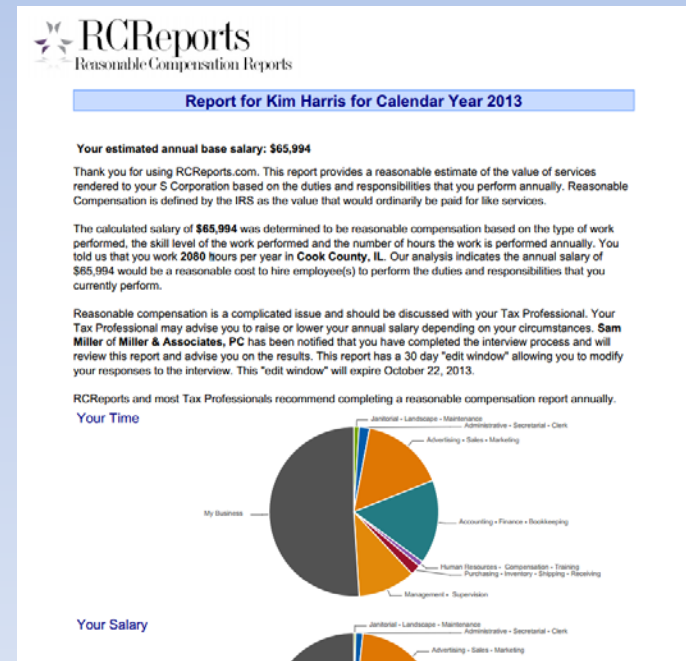
Reasonable Compensation Simplified™

Webcast Agenda

- About the Presenters
- Distribution V. Wages
- Reasonable Compensation in the courts
- IRS Guidelines
- Profitability V. Distributions
- IRS hot spot
- RCReports Demonstration
- Conclusion
- Q&A

RCReports, Inc.

- On-line application for determining Reasonable Compensation for Shareholder-Employees of S Corps
 - Tool for CPAs & Financial Advisors
 - IRS Criteria & Guidelines
 - Court Rulings
 - BLS Wage Estimates
 - Over 800 Occupational Profiles
 - 5,000+ geographic regions in the U.S.
- Paul Hamann
President
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Distribution V. Wages/Salary

Terms

- Reasonable Compensation = Replacement Cost 
- Reasonable Compensation = FMV Fair Market Value 
- Distributions = Dividends
- Distributions = Loan repayment, Return of basis
- Shareholder-employee (SE) = Corporate officer
- Shareholder-employee (SE) = S Corp owner

Distribution V. Wages/Salary

Wages/Salary = Payroll Taxes

Distributions \neq Payroll Taxes

Substantial Services = Reasonable Compensation

Distribution V. Wages/Salary

Example 1

- Scott Stone 100% of Stone Concrete (S Corp)
- Full Time Employee of Stone Concrete
- \$100,000 income before considering Scott's salary
- Scott takes a \$100,000 salary = taxable income is zero
- \$100,000 wages \longrightarrow 1040

Distribution V. Wages/Salary

Example 1 (continued)

- Scott and Stone Concrete responsible for Payroll Taxes
 - 7.65% Stone Concrete SS/Medicare = \$7,650
 - 7.65% Scott Stone SS/Medicare = \$7,650
 - State & Federal Unemployment Tax ???
- Total Tax Liability \$15,300+

Distribution V. Wages/Salary

Example 2

- Scott Stone 100% of Stone Concrete (S Corp)
- Full Time Employee of Stone Concrete
- \$100,000 income before considering Scott's salary
- Scott takes a \$100,000 distribution
- \$100,000 income \longrightarrow 1040

Distribution V. Wages/Salary

Example 2 (continued)

- Scott and Stone Concrete Payroll Taxes = \$0.00
 - Self Employment Tax = \$0.00
 - Income Tax (return of basis) = \$0.00
 - Total Tax Liability \$0.00
- Net tax savings \$15,300+

Distribution V. Wages/Salary

Wages/Salary



Distributions



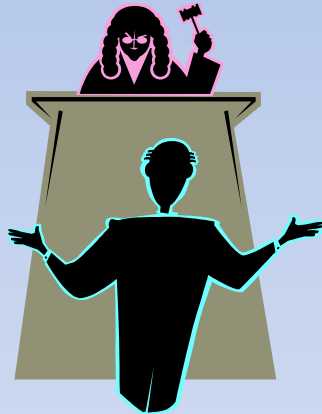
Distribution V. Wages/Salary

IRS REQUIREMENT:

"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."

Reasonable Compensation In the Courts

IRS 25-1*



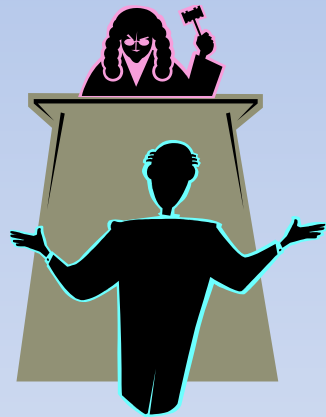
V



*Davis v. U.S.

Reasonable Compensation In the Courts

DAVID E. WATSON, P.C., V. UNITED STATES OF AMERICA



V



Reasonable Compensation In the Courts

- Low Salary V. Profit Distributions
 - 2002 Profit = \$203,651
 - 2002 Salary = \$24,000

 - 2003 Profit = \$175,470
 - 2003 Salary = 24,000

Reasonable Compensation In the Courts

- IRS Objected
 - Education
 - Graduate Degree
 - Experience
 - 20 Years
 - Time
 - Full Time (35-45 hours per week)

Reasonable Compensation In the Courts

IRS Audit 2007



Reasonable Compensation In the Courts

Reasonable Compensation

\$91,044 for 2002

\$91,044 for 2003

Reasonable Compensation In the Courts

	2002	2003
Reasonable Compensation	\$91,044	\$91,044
Actual Salary Paid	<u>\$24,000</u>	<u>\$24,000</u>
<u>Re-Characterized</u>	\$67,044	\$67,044

Total Re-Characterization = \$134,088

Reasonable Compensation In the Courts

\$48,521

\$20,000

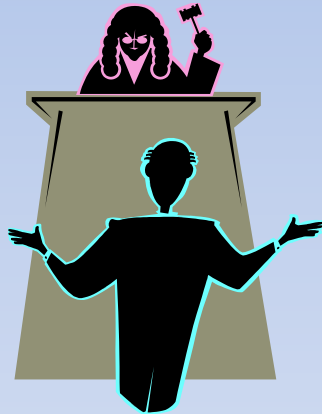
Reasonable Compensation In the Courts

Watson V. IRS



Reasonable Compensation In the Courts

Ruling in favor of IRS 2010



V



Reasonable Compensation In the Courts

IRS

- Graduate Degree
- 20 Years experience
- Full Time employee

Various Job Duties: ⚠️

- CPA/Accountant
- Partner
- Re-structured businesses for tax purposes

No Research and No Documentation

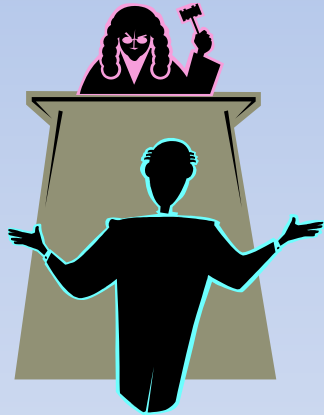
Reasonable Compensation In the Courts

Appealed



Reasonable Compensation In the Courts

Upheld District Courts ruling 2012

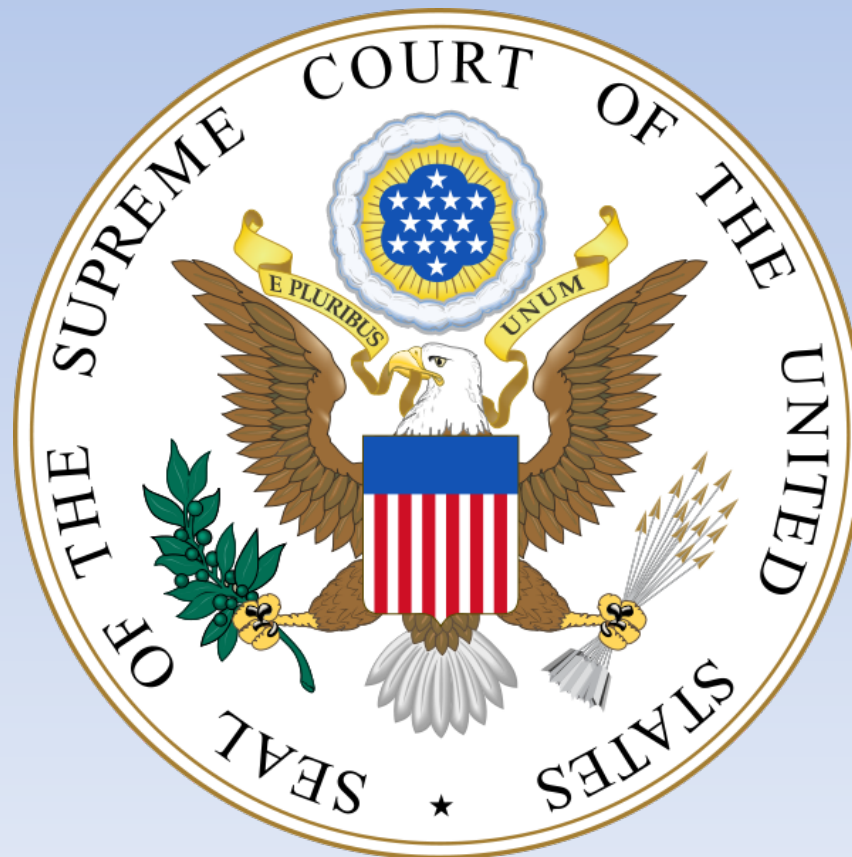


V



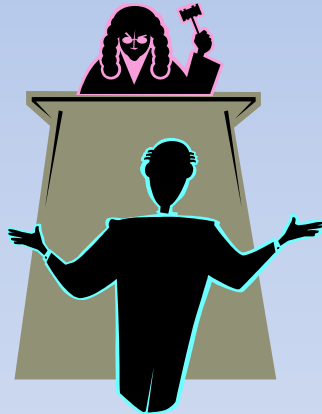
Reasonable Compensation In the Courts

Appeal Denied



Reasonable Compensation In the Courts

SEAN MCALARY LTD, INC. v. COMMISSIONER (IRS)



V



Reasonable Compensation In the Courts

McAlary Ltd = Real Estate Company

- Zero Salary V. Profit Distributions
- 2006 Net Income = \$231,454
- 2006 Distribution = \$240,000
- 2006 Salary = Zero

Reasonable Compensation In the Courts

IRS Calculation

\$100,755

- Primary Job Function – Real Estate Broker
- Full Time (12 hour days 6-7 days per week)
- Compared McAlary LTD performance with peers in the real estate industry 🚫

Reasonable Compensation In the Courts

IRS Calculation

\$100,755

- **Replacement Cost** – McAlary LTD could expect to pay \$48.44/hour to another individual in exchange for the services Mr. McAlary performed 🚩
- **Fair Market Value** – \$100,755 would be FMV of the services Mr. McAlary performed for his S Corp 🚩

Reasonable Compensation In the Courts

IRS Calculation

\$100,755

\$48.44 X 2080

- The Bureau of Labor Statistics defines Year-Round, Full-Time employment as **2,080** hours per year.
- 40 Hour Work Week X 52 Weeks/Year
- McAlary often worked 12 hour days with few days off

Reasonable Compensation In the Courts

McAlary Calculation

\$24,000

- Compensation Agreement 🚫
- BOD Meeting Minutes 04-01-2004
- Increases Based on Number of Agents

Reasonable Compensation In the Courts

Court Calculation

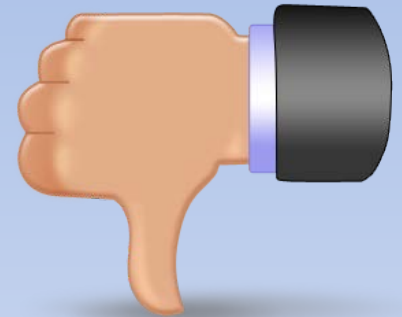
\$83,200

- Various Services 🚫
- BLS Wage Range
- Hourly Wage = \$40.00
- $2,080 \times \$40.00 = \mathbf{\$83,200}$

Reasonable Compensation In the Courts

Court Calculation

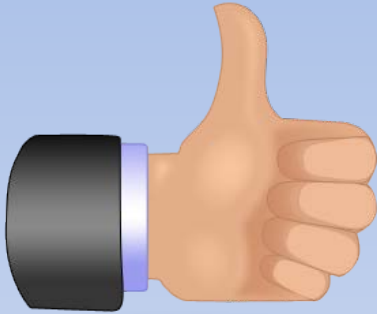
$$2,080 \times \$40.00 = \$83,200$$



Compensation Agreement – “We are not persuaded that the remuneration agreement represents a sound measure of the value of the services that Mr. McAlary provided ... The agreement clearly was not the product of an arm's-length negotiation.” 🚩


Industry Comparison – “ (IRS Expert) did not explain how a comparison of compensation measured as a percentage of gross receipts with compensation measured as a percentage of net sales would aid the Court ... In the end, we do not find this portion of (the experts) report to be persuasive or helpful. 🚩

Reasonable Compensation In the Courts



Court Calculation

$$2,080 \times \$40.00 = \mathbf{\$83,200}$$

- **Various Services** – Management; Supervision; Recruiting; Sales; Advertising; Purchasing; Bookkeeper; Record Keeping... 
- **Experience** – Low; New to the Industry
- **COESS-BLS** – Range \$32.99 to \$64.28

“Determining an employee's reasonable compensation is dependent upon a number of factors and is far from an exact science.”

Reasonable Compensation In the Courts

Court Rulings

- Sean McAlary Ltd, Inc. v. Commissioner 2013
- Glass Blocks Unlimited v. Commissioner 2013
- Patrick & Suzanne Herbert v. Commissioner 2012
- David E. Watson, P.C. v. United States 2010
- JD & Associates, LTD v. United States 2006
- Joseph M. Grey Public Accountant, P.C. v. Commissioner 2002
- Veterinary Surgical Consultants,P.C. v. Commissioner 2001
- Joly v. Commissioner 2000
- Spicer Accounting, Inc. v. United States 1990
- Joseph Radtke, S.C. v. United States,1989
-

IRS Guidelines

IRS Definition of Reasonable Compensation:

“Reasonable compensation is the value that would ordinarily be paid for like services by like enterprises under like circumstances”

IRS Code 162(a)(1):

“Reasonable & Services Rendered”

(Replacement Cost or Fair Market Value)

IRS Guidelines

Notice of Acceptance as an S Corporation

We would also like to take this opportunity to inform you of your tax obligations related to the payment of compensation to shareholder-employees of S corporations.

When a shareholder-employee of an S Corporation provides services to the S corporation, reasonable compensation generally needs to be paid. This compensation is subject to employment taxes.

Tax practitioners and subchapter S shareholders need to be aware that Revenue Ruling 74-44 states that the Internal Revenue Service (IRS) will re-characterize small business corporation dividends paid to shareholders as salary when such dividends are paid to the shareholders in lieu of reasonable compensation for services.

This position has been supported in several recent court decisions.

Distribution V. Wages/Salary

INTERNAL REVENUE SERVICE		
IRS		Fact Sheet
Media Relations Office	Washington, D.C.	Media Contact: 202.622.4000
www.IRS.gov/newsroom		Public Contact: 800.829.1040


Wage Compensation for S Corporation Officers

FS-2008-25, August 2008

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.

Distribution V. Wages/Salary

Some factors considered by the courts in determining reasonable compensation:

- 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
- What comparable businesses pay for similar services
- Compensation agreements 
- The use of a formula to determine compensation

IRS Guidelines

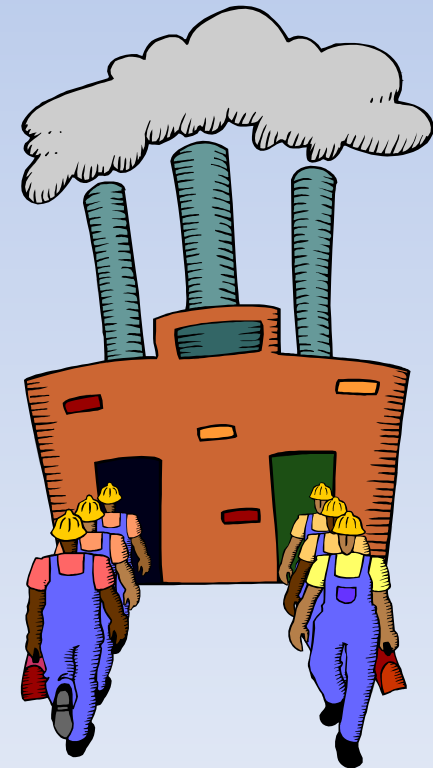
The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation

1. Services of non-shareholder employees
2. Capital and equipment
3. Services of shareholders



IRS Guidelines

Services of non-shareholder employees, or
Capital and equipment



IRS Guidelines

Services of shareholder

In addition to the shareholder-employee direct generation of gross receipts, the shareholder-employee should also be compensated for administrative work performed !



IRS Guidelines

Services of shareholder

Factors in determining reasonable compensation:

1. **Training and experience**



&



IRS Guidelines

Services of shareholder

Factors in determining reasonable compensation:

2. Duties and responsibilities



&



IRS Guidelines

Services of shareholder

Factors in determining reasonable compensation:

3. Time and effort devoted to the business



&

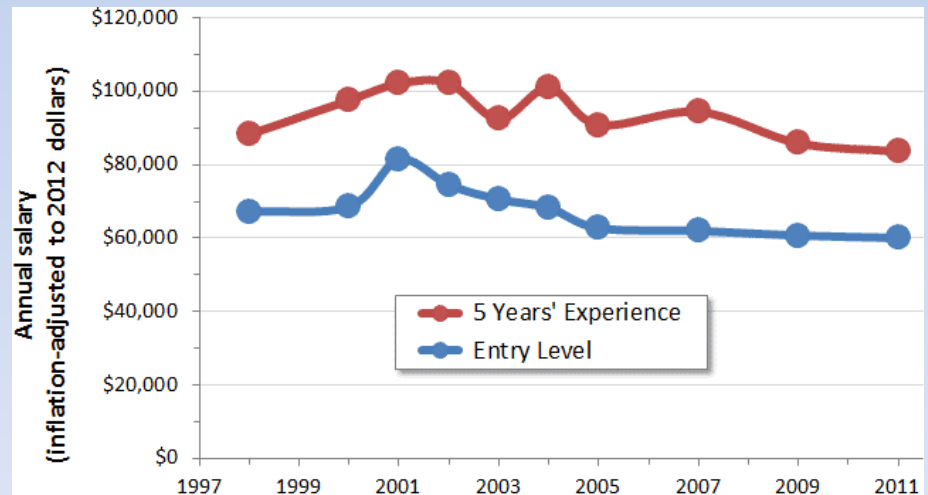


IRS Guidelines

Services of shareholder

Factors in determining reasonable compensation:

4. What comparable businesses pay for similar services

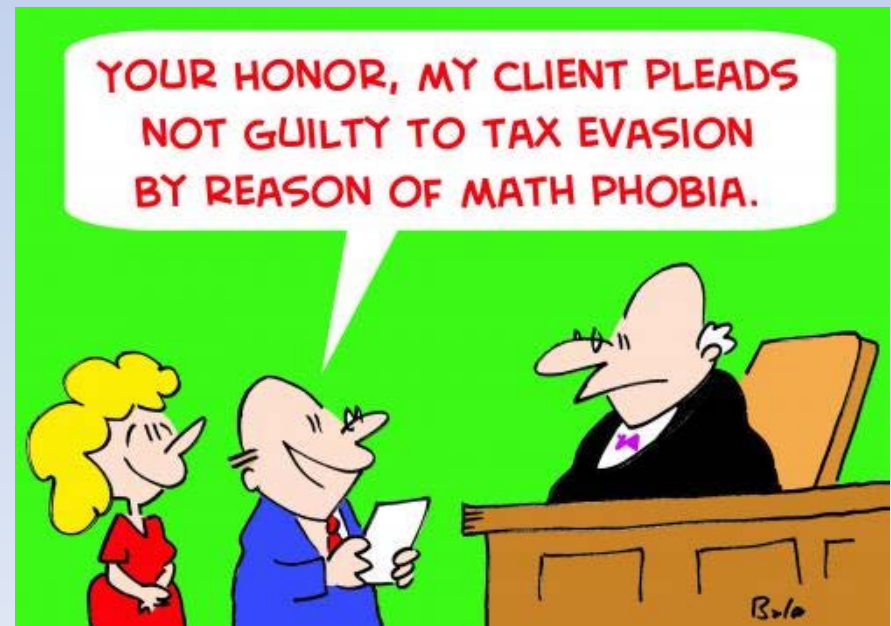
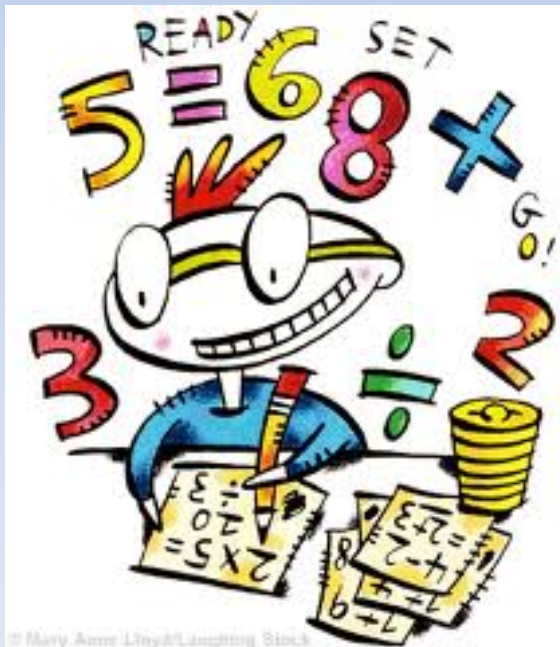


IRS Guidelines

Services of shareholder

Factors in determining reasonable compensation:

5. The use of a formula to determine compensation

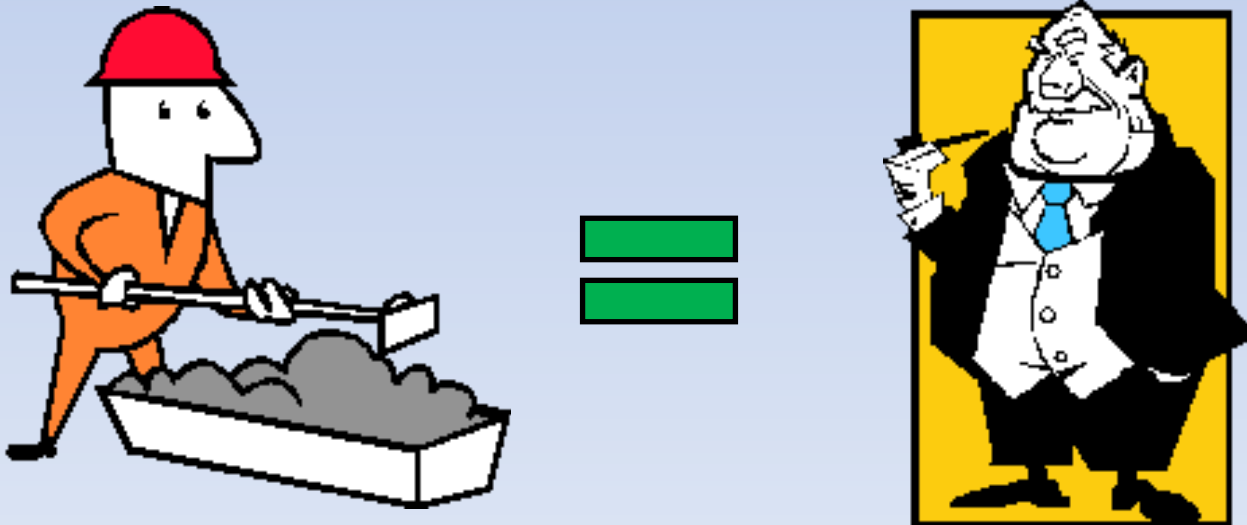


IRS Guidelines

Services of shareholder

Factors in determining reasonable compensation:

6. Payments to non-shareholder employees



IRS Guidelines

Services of shareholder

Factors in determining reasonable compensation:

7. Compensation agreements



IRS Guidelines

Services of shareholder

Factors in determining reasonable compensation:

8. **Timing and manner of paying bonuses to key people**

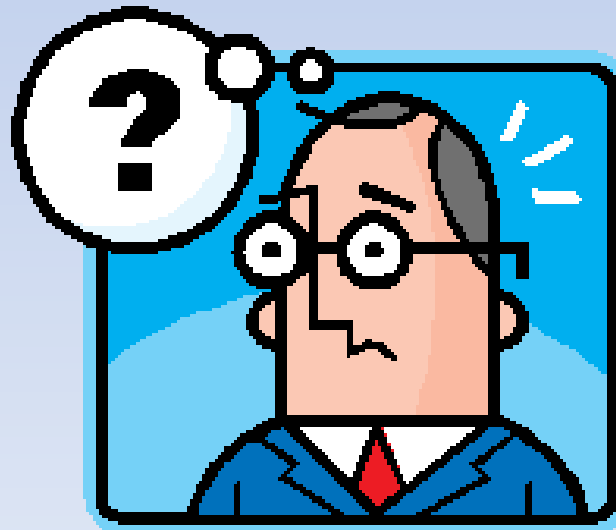


IRS Guidelines

Services of shareholder

Factors in determining reasonable compensation:

9. Dividend history



Profitability V. Distributions



“The amount of reasonable compensation will never exceed the amount received by the shareholder either directly or indirectly.”

Profitability V. Distributions

Example 1

- Scott Stone 100% of Stone Concrete (S Corp)
- Scott's RC figure = \$74,685
- 2011 Stone Concrete Net Profit = \$190,000
- Scott takes \$160,000 out of Stone Concrete
- Scott receives wages (RC) of \$74,685
- Scott receives a distribution of \$85,315
\$160,000

Profitability V. Distributions

Example 2

- Scott Stone 100% of Stone Concrete (S Corp)
- Scott's RC figure = \$74,685
- 2012 Stone Concrete Net Profit = \$23,000
- Scott takes \$30,000 out of Stone Concrete
- Scott receives wages (RC) of \$30,000
- Scott receives a distribution of $\$ \underline{\quad 0}$
 $\underline{\underline{\$30,000}}$

Profitability V. Distributions

Example 3

- Scott Stone 100% of Stone Concrete (S Corp)
- Scott's RC figure = \$74,685
- 2012 Stone Concrete Net Profit = \$150,000
- Scott takes \$0 out of Stone Concrete
- Scott receives wages (RC) of \$ 0.00
- Scott receives a distribution of \$ 0.00
\$ 0.00

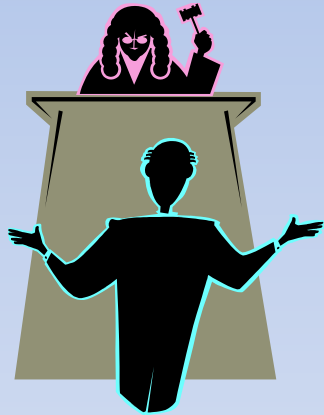
Profitability V. Distributions

Example 4

	2010	2011	2012	Total
Scott RC	\$75k	\$75k	\$75k	\$225k
Net Profit	\$130k	\$135k	\$145k	\$410k
Scott Takes	\$0	\$0	\$400k	
Wages	\$0	\$0	\$225k	
Distribution	\$0	\$0	\$175k	

Shareholder Loan V. Distributions

GLASS BLOCKS UNLIMITED v. COMMISSIONER (IRS)



V



Shareholder Loan V. Distributions

Loan or a Capital Contribution

- Written Agreement or Promissory note
- Interest Charged
- Loan Collateralized
- Fixed Repayment Schedule

example
Promissory Note

I, Local Boy, do promise to pay
Aunt Mele, the sum of \$ 10,000.

Repayment to be made in the
form of 200 equal payments at
5%, payable on the 1st of each
month, starting 8/1/2012, until
the total debt is satisfied.

Signed,
Local Boy
7/1/2012

Shareholder Loan V. Distributions

Loan or a Capital Contribution

Where the expectation of repayment depends solely on the success of the borrower's business, rather than on an unconditional obligation to repay, the transaction has the appearance of a capital contribution.

Shareholder Loan V. Distributions

Loan or a Capital Contribution

One must determine whether the loan, analyzed in terms of economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or a strict debtor-creditor relationship.

Reasonable Compensation - IRS Hot Spot

Prior to 2005 the most recent compliance study of S corporations involved about 10,000 returns from tax year 1984



Reasonable Compensation - IRS Hot Spot

TIGTA 7-2002:

The IRS does not always address S Corp officer compensation during examination

- Reviewed 84 S Corp returns that had been audited: The average wages were \$5,300 and the average distribution was \$349,323 **(PROBLEM)**
- It is critical for the examiner to determine the level of service provided by the SE before an allocation of officer compensation can be made **(TRAINING)**
- Recommend that the Director of Compliance for SB/SE division provide technical guidance and resources (such as software) to field personnel to aid in determining reasonable officer compensation **(TOOLS)**

Reasonable Compensation - IRS Hot Spot

TIGTA 5-2005:

Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations

- The S corporation form of ownership has become a multibillion dollar employment tax shelter – \$5.7 billion in TY 2000 **(PROBLEM)**
- Trends point to continued erosion of the employment tax base and resulting reductions in Social Security and Medicare revenues **(PROBLEM)**

Reasonable Compensation - IRS Hot Spot

IRS 7-2005:

IRS Launches Study of S Corporation Reporting Compliance

- National Research Project (NRP) 2005 – 50,000 randomly selected S Corp returns
- “The use of S corporations has exploded,” said IRS Commissioner Mark W. Everson. “The IRS needs a better understanding of what this means for tax compliance. This research is critical for achieving our strategic goal of ensuring that corporations and high-income individuals are paying their fair share.”
- When completed, this research will assist the IRS in selecting and auditing S corporation returns with greater compliance risk

Reasonable Compensation - IRS Hot Spot

TIGTA 8-2006:

Filing Characteristics and Examination Results for Partnerships and S Corporations

- Minimizing the amount of employment taxes that must be paid can be particularly **attractive** benefits and may be a primary reason why S corporations have become the most common type of corporate entity filing income tax returns with the IRS (**PROBLEM**)
- Although the IRS has historically emphasized examining taxable entities, such as sole proprietorships, it is moving away from this emphasis and towards one that is focused on maintaining examination coverage across all filing segments and on areas presenting the highest compliance risk. This new focus will likely contribute to an **increase** in the numbers of partnership and **S corporation** tax returns examined (**Increase in Audits**)

Reasonable Compensation - IRS Hot Spot

TIGTA April 2008:

Additional Actions Are Needed to Effectively Address the Tax Gap

- There are potential abuses of employment tax laws caused by single shareholder owners of Subchapter S corporations **(PROBLEM)**
- Estimated it would cost the Department of the Treasury approximately \$60 billion in employment taxes over 5 years **(PROBLEM)**

Reasonable Compensation - IRS Hot Spot

GAO December 2009

Actions Needed to Address Noncompliance with S Corporation Tax Rules

- 68 percent of S corporation returns filed for tax years 2003 and 2004 misreported at least one item affecting net income
- For those years, the overall net misreported amount that S corporations passed through to individual shareholders was about \$85 billion
- JCT & TIGTA reports show that inadequate shareholder wage compensation is a **SIGNIFICANT** issue

Reasonable Compensation - IRS Hot Spot

GAO December 2009

Actions Needed to Address Noncompliance with S Corporation Tax Rules

- S corporations failed to pay adequate wages to shareholders for their labor for the corporation
- GAO calculated that in the 2003 and 2004 tax years, the net shareholder compensation underreporting equaled roughly \$23.6 billion

Reasonable Compensation - IRS Hot Spot

Noncompliance was the highest in not paying the correct wage compensation to S corporation shareholders

Table 2: Most Common Misreported Line Items by Number of S Corporations Misreporting and Amounts Misreported (Absolute Dollar Values), Tax Years 2003 and 2004 Combined

Misreported line items	Number misreported (in thousands)	Net misreported amount (in billions)	Median misreported amount
Net income ^a	4,542	\$84.8 ^c	\$5,459 ^d
Other deductions ^b	3,532	37.2 ^c	4,204 ^d
Distributions^f	1,852	61.8 ^h	7,411^f
Gross receipts or sales	1,508	25.8 ^h	3,988 ^g
Cost of goods sold	1,311	— ^e	3,003 ^g
Depreciation expense	1,000 ^c	5.7 ^h	1,755 ⁱ
Shareholder compensation	887^c	23.6^d	20,127^d
Purchases	801 ^c	— ^e	2,031 ^h
Taxes and license expense	651 ^c	1.4 ^g	271 ^h
Repairs and maintenance expense	585 ^c	2.8 ^g	1,505 ^g
Interest expense	574 ^c	2.3 ^g	985 ^h

Reasonable Compensation - IRS Hot Spot

GAO December 2009

Actions Needed to Address Noncompliance with S Corporation Tax Rules

- When examiners used BLS statistics as their benchmarking tool, they adjusted shareholder compensation 66% of the time.
- Implementing such a tool could improve the effectiveness of IRS examinations of shareholder compensation
- The adjustment amount when using BLS data averaged \$30,000. 50% more than the median of \$20,000

Reasonable Compensation - IRS Hot Spot

GAO December 2009

Actions Needed to Address Noncompliance with S Corporation Tax Rules

Recommendations:

- Further analyze the extent of noncompliance involving a long standing concern over inadequate shareholder compensation, and identify options for improving compliance **(PROBLEM)**
- Improve guidance to IRS examiners so that they might better target and determine adequate shareholder compensation **(TRAINING & TOOLS)**

Reasonable Compensation - IRS Hot Spot

TIGTA June 2012

The Recommended Adjustments From S Corporation Audits Are Substantial, but the Number of No-Change Audits Is a Concern

- The number of audits closed with no recommended adjustments is very high for returns selected by the DIF system (62%).
- The IRS plans to analyze S corporation data files in order to better identify productive S corporation returns for audit

Reasonable Compensation - IRS Hot Spot

TIGTA June 2012


The Recommended Adjustments From S Corporation Audits Are Substantial, but the Number of No-Change Audits Is a Concern

- In FYs 2007 through 2011, SB/SE Division examiners completed 53,544 audits of S corporation returns
- Recommended \$5.7 billion in adjustments
- For each return audited in FYs 2007 through 2011, examiners generated about \$105,534 in recommended adjustments

Reasonable Compensation - IRS Hot Spot

TIGTA June 2012

The Recommended Adjustments From S Corporation Audits Are Substantial, but the Number of No-Change Audits Is a Concern

The large number of recommended adjustments, combined with two other factors, will likely **lead to an increase in the number of S Corp audits.** 

1. Growing number of S Corps
 - A. 1997 to 2011 S Corp returns increased from 2.5 million to 4.5 million an 80% increase
 - B. 5.7 million S Corp returns by 2015 an increase of 26% over 2011
2. Compliance risk they pose (Reasonable Compensation)
 - A. 94% of S Corps are held by 3 or fewer shareholders

Reasonable Compensation - IRS Hot Spot

TIGTA June 2012

The Recommended Adjustments From S Corporation Audits Are Substantial, but the Number of No-Change Audits Is a Concern

Recommendations:

- The Director, Research, SB/SE Division, should analyze S corporation data files to develop audit leads to help select additional productive returns for audit
- Improve guidance to IRS examiners so that they might better target and determine adequate shareholder compensation **(TRAINING & TOOLS)**

RCReports Demonstration

Reasonable Compensation: \$ 84,154
Calendar Year 2003

Management - Supervision

33% of your time

686 hours/year

48.01% of comp.

Task

Proficiency

Category

Overall

Hours

Wage

Annual

General and Operations Managers

High

100%

33%

686.4

\$ 58.86

\$ 40,402

My Business

67% of your time

1,394 hours/year

51.99% of comp.

Task

Proficiency

Category

Overall

Hours

Wage

Annual

Accountants, Certified Public

High

50%

33.5%

696.8

\$ 29.73

\$ 20,716

Business Management Analysts

High

50%

33.5%

696.8

\$ 33.06

\$ 23,036

Conclusions

COMPENSATION PAID TO SHAREHOLDERS WHO PERFORM SERVICES



Conclusions

Underpayment of salaries results in the large underpayment of FICA taxes, and encourages the IRS to proactively pursue the issue



Conclusions

Distributions to a shareholder who performs services to their S Corp will be re-characterized as wages if the distributions are actually disguised compensation

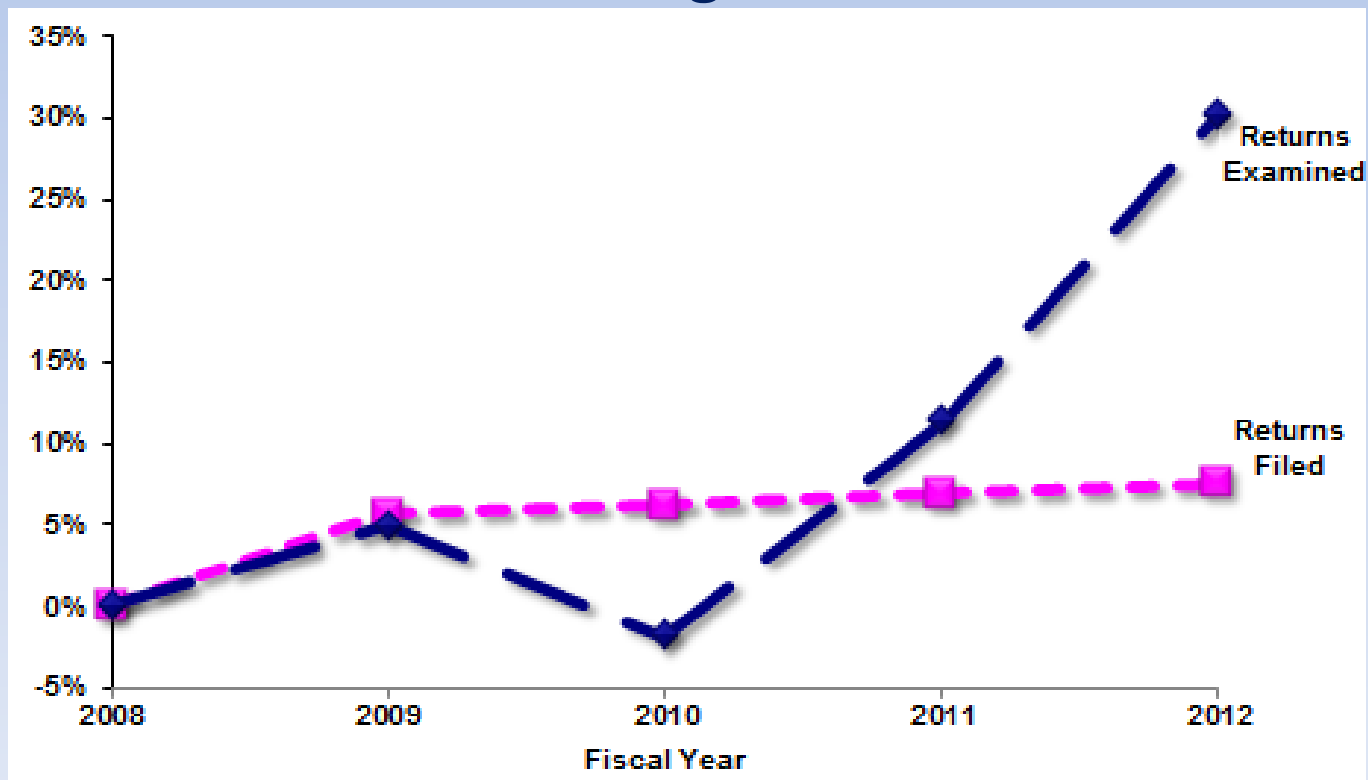
UNREAL CORPORATION	Check #	12345
Payroll Account	Date:	July 31, 20XX
Pay to the order of	<u>I. M. Fictitious</u>	\$1,834.00
*****One-Thousand, Eight-Hundred, Thirty-Four and no/100 Dollars*****		
NOT a REAL Bank		
Memo	July payroll for Fictitious	<i>Certainly Void</i>
<i>Detach below before depositing, and save for your records:</i>		
Employee: I. M.	Gross Earnings	\$3,000.00
Pay Period: July 20XX	Deductions:	
	Federal Income Tax	\$349.00
	State Income Tax	117.00
	Social Security	180.00
	Medicare/Medicaid	45.00
	Insurance	175.00
	Retirement Savings Plan	200.00
	Charity	25.00
	Health/Child Care Flex Plan	75.00
	Net Pay	\$1,834.00



Conclusions

Expect an Increase in S Corp audits !

TIGTA August 2013



Conclusions

Who should Research and Document their Reasonable Compensation Figure

Any Shareholder-Employee of an S Corp who performs services for their company



Conclusions

How to support your Reasonable Compensation Figure

- Develop a consistent year to year Reasonable Compensation policy
- Determine your Reasonable Compensation figure using the IRS guidelines and the 9 factors handed down by the courts
- Add your Reasonable Compensation documentation, reasoning, and notes to your corporate minutes

Conclusions

Compensation must be both REASONABLE & SUPPORTABLE with clear DOCUMENTATION outlining how the compensation figure was reached

Report for Scott Stone for Calendar Year 2013

Your estimated annual base salary: \$74,685

Thank you for using RCReports.com. This report provides a reasonable estimate of the value of services rendered to your S Corporation based on the duties and responsibilities that you perform annually. Reasonable Compensation is defined by the IRS as the value that would ordinarily be paid for like services.

The calculated salary of **\$74,685** was determined to be reasonable compensation based on the type of work performed, the skill level of the work performed and the number of hours the work is performed annually. You told us that you work **2080** hours per year in **Cook County, IL**. Our analysis indicates the annual salary of **\$74,685** would be a reasonable cost to hire employee(s) to perform the duties and responsibilities that you currently perform.

Reasonable Compensation for Shareholder-Employees of S Corps

Presented by RCReports, Inc.

Reasonable Compensation Simplified™

Paul Hamann

President

720-833-7399

phamann@RCReports.com