

IRS Audit Issue – S Corporation Reasonable Compensation

Roger McEowen (roger.mceowen@washburn.edu) – Washburn University School of Law
May 2022

Agricultural Law and Taxation Blog, by Roger McEowen: <https://lawprofessors.typepad.com/agriculturallaw/>
Used with permission from the Law Professor Blog Network

Overview

One of the areas of “low-hanging fruit” for IRS auditors in recent years involves the issue of reasonable compensation in the S corporation context. But what does “reasonable compensation” mean? The instructions to Form 1120S, the return for an S corporation, says, “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.” But that still doesn’t answer the question of what “reasonable compensation” is. The question is important because setting compensation properly avoids IRS assessing tax, penalties, and interest.

What is “reasonable compensation” and how is it determined? Reasonable compensation for an S corporation shareholder-employee – it’s the topic of today’s post.

In General

An S corporation shareholder must include in income the shareholder’s pro rata share of the S corporation earnings for the year. The pro rata share can be split between compensation for services and a deemed or actual distribution of S corporate income. The distinction matters because employment-related taxes apply to compensation paid for the shareholder’s services, but do not apply to deemed or actual distributions of S corporate income. *I.R.C. §1373; Rev. Rul. 59-221. 1959-1 C.B. 225.* Thus, compensation that is “too low” in relation to the services rendered to the S corporation results in the avoidance of payroll taxes. i.e., the employer and employee portions of Federal Insurance Contributions Act (FICA) taxes and the employer Federal Unemployment Tax Act (FUTA) tax. S corporation flow-through income is taxed at the individual level and is (normally) not subject to self-employment tax. Also, in addition to avoiding FICA and FUTA tax via S corporation distributions, the 0.9% Medicare tax imposed by I.R.C. §3101(b)(2) for high-wage earners (but not on employers) is also avoided by taking income from an S corporation in the form of distributions.

Note: The different tax treatment of employment-related wages and compensation for services rendered to the S corporation provide an incentive for S corporation shareholder-employees to take less salary relative to distributions from the corporation. With the Social Security wage base set at \$147,000 for 2022, setting a shareholder-employee’s compensation beneath that amount with the balance of compensation consisting of dividends can produce significant tax savings.

IRS Examination of “Employee” Status

What is an “employee”? Many S corporations, particularly those that involve agricultural businesses, have shareholders that perform substantial services for the corporation as officers and otherwise. In fact, the services don’t have to be substantial. Indeed, under a Treasury Regulation, the provision of more than minor services for remuneration makes the shareholder an “employee.” *Treas. Reg. §31.3121(d)-1(b).* Once, “employee” status is achieved, the IRS views either a low or non-existent salary to a shareholder who is also an officer/employee as an attempt to evade payroll taxes and, if a court determines that the IRS is correct, the penalty is 100 percent of the taxes owed. “Wages” for federal employment tax



purposes means all remuneration for employment. *I.R.C. §3121(a); 3306(b)*. The Regulations point out that the form in which payment is made doesn't matter. The real question is whether compensation was made for employment. *Treas. Reg. §§31.3121(a)-1(b) and 31.3306(b)-1(b)*. If it was, employment taxes apply to both the employee and the S corporation. See, e.g., *Veterinary Surgical Consultants, P.C. v. Comr.*, 117 T.C. 141 (2001), *aff'd. sub. nom.*, *Yeagle Drywall Co.*, 54 Fed. Appx. 100 (3d Cir. 2002).

Definition of “wages.” For employment tax purposes, “wages” means remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. *I.R.C. §§3121(a); 3306(b); 3401(a)*. The remuneration must be paid for services of any nature performed by an employee. *I.R.C. §3121(b)*. It is immaterial how an employer characterizes the payment, and the form of the payment also does not matter. *Treas. Regs. §§31.3121(a)-1; (c) and (e); 31.3401(a)-1 – (a)(2) and (a)(4)*. In addition, an employee cannot waive the right to receive wages and characterize payments received as something other than wages.

Audit focus. An IRS audit on the issue tends to focus on the amount of compensation, whether it is reasonable based on the facts and whether the proper amount of employment-related taxes have been paid. The burden is on the corporation to establish that the salary amount under question is reasonable. Likewise, IRS is likely to not distinguish between payments an S corporation makes to a shareholder that are allegedly attributable to the shareholder's status as an officer and shareholder rather than as an employee. The courts have supported the IRS on this point, and repeatedly point out that employee status is achieved once anything more than minor services are provided to the corporation. *Id.*; *I.R.C. §3121(d)(1)*.

The IRS also has the authority to reclassify “distributions” made to an S corporation shareholder as payment for wages. *I.R.C. §7436; Rev. Rul. 74-44, 1974-1 C.B. 287*. The reclassification issue can be a critical issue when a shareholder's family member provides capital or services to the corporation. In that situation the IRS has the power to make any adjustments necessary to reflect the reasonable value of the capital or services provided based on the particular facts. Key to any IRS adjustment would be what the corporation would have had to pay for the capital or services had it not been provided by a family member who was also not a shareholder in the S corporation. Likewise (and a big issue in some farming operations), if a shareholder's family member has an interest in another pass-through entity and that entity provides services or capital to the S corporation, the IRS can make appropriate adjustments to reflect the value of the services and/or capital provided.

Note: A “family member” of an S corporation shareholder includes only the shareholder's spouse, ancestors, lineal descendants and any trust for the primary benefit of any of these individuals. *Treas. Reg. §1.1366-3*.

Determining Reasonableness

What's the source of gross receipts? A key question in determining reasonableness of compensation is the source of S corporation gross receipts and the shareholder's activity (if any) in generating those receipts. What did the shareholder/employee do for the S corporation? Or, alternatively, did the S corporation's gross receipts derive from the personal services of non-shareholder employees or shareholders? If the gross receipts derived from non-shareholder personal services (as well as capital and equipment) payments in return are nonwage distributions – hence, not subject to employment taxes. If the source of the S corporation's gross receipts is from shareholder personal services, payments for those services are wages even if those personal services did not directly produce the gross receipts.

Note: If S corporate gross receipts derive from the services of non-shareholder employees, or capital and equipment, then they should *not* be associated with the shareholder/employee's personal services, and it is reasonable that the shareholder would receive distributions as well as compensation. Alternatively, if most



of the gross receipts and profits are associated with the shareholder's personal services, then most of the profit distribution should be classified as compensation.

In addition to the shareholder/employee's direct generation of gross receipts, the shareholder/employee should also be compensated for administrative work performed for the other income-producing employees or assets. As applied in the ag context, for example, this means that reasonable compensation for a shareholder/employee in a crop farming operation could differ from that of a shareholder-employee in a livestock operation.

IRS factors. The IRS examines numerous factors to determine if reasonable compensation has been paid. The following is a list of some of the primary ones:

- The employee's qualifications;
- Training and experience;
- The nature, extent, and scope of the employee's work;
- The amount of time and effort devoted to the S corporation's business activities;
- The S corporation's dividend history;
- The size and complexities of the business; a comparison of salaries paid;
- The prevailing general economic conditions;
- Comparison of salaries with distributions to shareholders;
- The prevailing rates of compensation paid in similar businesses;
- Whether payments are made to non-shareholder employees;
- The timing and manner of paying bonuses to key people in the S corporation;
- The presence of any compensation agreements;
- The taxpayer's salary policy for all employees (are any formulas used for determining compensation?);
- What is the amount paid out as salary as compared to amounts distributed as profit: and
- In the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years.

Court Cases on Reasonable Compensation

Before 2005, the court cases involved S corporation owners who received *all* of their compensation in form of dividends. Most of the pre-2005 cases involved reclassifications on an all-or-nothing basis. In 2005, the IRS issued a study entitled, "S Corporation Reporting Compliance." Now the courts' focus is on the reasonableness of the compensation in relation to the services provided to the S corporation. That means each situation is fact-dependent and is based on the type of business the S corporation is engaged in and the amount and value of the services rendered.

Recent cases. For those interested in digging into the issue further, the following cases are instructive:

- *Watson v. Comr.*, 668 F.3d 1008 (8th Cir. 2012);
- *Sean McAlary Ltd., Inc. v. Comr.*, T.C. Sum. Op. 2013-62;
- *Clary Hood, Inc. v. Comr.*, T.C. Memo. 2022-15;
- *Glass Blocks Unlimited v. Comr.*, T.C. Memo. 2013-180; and



- *Scott Singer Installations, Inc. v. Comr., T.C. Memo. 2016-161; A.O.D. 2017-04 (Apr. 10, 2017) (in result only).*

Each of these cases provides insight into the common issues associated with the reasonable compensation issue. The last two also address distributions and loan repayments in the context of reasonable compensation of unprofitable S corporations with one case being a taxpayer victory and the other a taxpayer loss.

Reasonable compensation for an ag producer. Based on the above analysis and commentary, what would “reasonable compensation be for a farmer or rancher as a shareholder of an S corporation? The answer is that “it depends.” Certainly, there is no need to set compensation at the Social Security wage base - \$147,000 for 2022. An acceptable compensation rate (in the eyes of the IRS) will depend on numerous factors, including whether the business involves livestock. Wage rates for ag labor can be obtained from many Land Grant Universities. For an owner/manager, an additional amount of compensation should be added to the labor rate to reflect managerial and administrative duties. An acceptable range is likely somewhere in the \$40,000-\$70,000 range. But, that is merely a suggested range. Each S corporation will need to carefully determine what it believes is a reasonable rate based on the circumstances and document in corporate records how that rate was determined. A commitment should then be made to revisit compensation levels on a periodic basis.

Note: As a rule-of-thumb, when considering whether or not to utilize the S corporation structure is achieving tax savings of at least \$10,000 annually. With an S election comes additional bookkeeping, payroll and unemployment tax filings and other administrative duties.

Return Preparation

It is critical that workpapers associated with the preparation of an S corporation’s return include sufficient documentation supporting the level of compensation to a shareholder-employee. That documentation should evidence, at a minimum, the type of work the shareholder performed for the corporation, the hours of work spent on corporate business, and how the compensation level was determined.

Other Issues

Qualified Business Income. S corporate reasonable compensation also bears on the shareholder’s qualified business income (QBI) deduction (I.R.C. §199A) computation. An S corporation shareholder is allocated a pro rata share of the S corporation’s QBI. As part of that computation, the S corporation deducts W-2 wages (including reasonable compensation paid to shareholders) as an expense allocable to the corporation’s trade or business when the corporation calculates its QBI deduction. *Treas. Reg. §1.199A-2(b)*. But the shareholder cannot increase the shareholder’s QBI by the amount of reasonable compensation the S corporation pays. *Treas. Reg. §1.199A-3(b)(2)(ii)(H)*.

Note: There are numerous factors that determine whether a particular type of entity will generate a relatively larger QBI deduction. One of those factors, in the S corporation context, is the level of “reasonable compensation” paid to shareholder-employees.

Shareholder advances. In small, closely-held S corporations in which a family farming (or other) business is operated, there sometimes is a tendency to use the S corporation to pay personal expenses on a shareholder’s behalf. The question that arises in this situation is whether the payment constitutes wages as compensation for services rendered to the corporation that are subject to federal employment taxes. Key to answering this question is determining whether a bona fide debtor-creditor relationship exists. A genuine intent to create a debt coupled with a reasonable expectation of repayment that comports with economic reality is critical in establishing that the payment should *not* be characterized as wages. If the corporation



reports the amounts advanced on its general ledger and corporate returns as loans, and actual payments on the advanced funds are made, the argument is strengthened that the amounts advanced are *not* wages. Clearly, the use of interest-bearing secured promissory notes also bolsters the argument that advances are not wages. But, if the advances are merely a paper transaction where the outstanding “loan” balance is credited against undistributed income and any rental payments the corporation owes to a shareholder, the “loan” constitutes wages for FICA and FUTA purposes. See, e.g., *Gale W. Greenlee, Inc. v. United States*, 661 F. Supp. 642 (D. Colo. 1985).

Conclusion

The bottom line is that “reasonable compensation” means that it must be reasonable for all of the services the S corporation owner performs for the corporation. Because there is no safe harbor for reasonable compensation, the best strategy is to research and document reasonable compensation every year. That will provide a defensible position if the IRS raises questions on audit.

For more information about this publication and others, visit AgManager.info.

K-State Agricultural Economics | 342 Waters Hall, Manhattan, KS 66506-4011 | 785.532.1504

www.ageconomics.k-state.edu

Copyright 2021: AgManager.info and K-State Department of Agricultural Economics

