S Corporations - Reasonable Compensation; Non-Wage Distributions and a Legislative Proposal

Roger McEowen (roger.mceowen@washburn.edu) – Washburn University School of Law
October 2021
Agricultural Law and Taxation Blog, by Roger McEowen: https://lawprofessors.typepad.com/agriculturallaw/
Used with permission from the Law Professor Blog Network

Overview

Operating a small business means, in part, paying business taxes. But, business taxes for many small businesses are different than those that are taken out of an employee's paycheck. Under current law, there can be an advantage for many small businesses, particularly those engaged in professional services, to operate in the form of an S corporation. But, that advantage could be eliminated under a proposal that is under consideration in the Congress.

S corporation tax treatment and a current legislative proposal – it's the topic of today's post.

S Corporation Tax Treatment

Many small businesses are subject to the Self-Employment Contributions Act (SECA), and self-employment tax must be paid. But S corporation shareholders are not subject to SECA tax because the S corporation is treated as separate from the shareholders – its activities are not attributed to its shareholders. An S corporation must pay its owner-employees "reasonable compensation" for services rendered to the corporation. That compensation is subject to Federal Insurance Contributions Act (FICA) tax. But any non-wage distributions to S corporation shareholders are not subject to either FICA or SECA taxes. Therein lies the "rub." Salary that is too low in relation to the services rendered results in the avoidance of payroll taxes. So, when shareholder-employees take flow-through distributions from the corporation instead of a salary, the distributions are not subject to payroll taxes (i.e., the employer and employee portions of FICA taxes and the employer Federal Unemployment Tax Act (FUTA) tax.

Note: FICA requires employers to withhold a set percentage of each employee's paycheck to cover the Social Security tax, Medicare tax and other insurance costs. Employer's must also equally match those withholdings, with the total amount being 15.3 percent of each employee's net earnings. Under SECA, a small business owner is deemed to be both the employer and the employee and is, therefore, responsible for the full 15.3 percent "self-employment tax" that is paid out of net business earnings

In accordance with Rev. Rul. 59-221, 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. These are the tax incentives for S corporation shareholder-employees to take less salary relative to distributions from the corporation. With the Social Security wage base set at $142,800 for 2011, setting a shareholder-employee's compensation beneath that amount with the balance of compensation consisting of dividends can produce significant tax savings.

Note: It is currently projected that the Social Security wage base will be $146,700 for 2022.

Who's an "Employee"?

Most 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." 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. Of course, the burden is on the corporation to establish that the salary amount under question is reasonable.

Determining Reasonableness

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.

So what are the factors that the IRS examines to determine if reasonable compensation has been paid? Here's a list of some of the primary ones:

- The employee's qualifications;
- the nature, extent, and scope of the employee's work;
- 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;
- the taxpayer's salary policy for all employees; 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.

According to the IRS, the key to establishing reasonable compensation is determining what the shareholder/employee did for the S corporation. That means that the IRS looks to the source of the S corporation's gross receipts. If they came from 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 allocated 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.

Recent Cases

For those interested in digging into the issue further, I suggest reading the following cases:

- Watson v. Comr., 668 F.3d 1008 (8th Cir. 2012)
- Sean McAlary Ltd., Inc. v. Comr., T.C. Sum. Op. 2013-62
- Glass Blocks Unlimited v. Comr., T.C. Memo. 2013-180
- Scott Singer Installations, Inc. v. Comr., T.C. Memo. 2016-161

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.

Legislative Proposal

A current proposal, effective for tax years beginning after December 31, 2021, that would change the tax rules applicable to S corporations is being considered as part of the massive spending bills that are currently before the Congress. The proposal is an attempt to ensure that all of the pass-through business income that an individual receives that has more than $400,000 of adjusted gross income for the tax year is subject to the 3.8 percent Medicare tax – either through the tax on net investment income (I.R.C. §1411) or through the SECA tax. This outcome would be accomplished by the legislation amending the definition of "net investment income" so that it includes an individual's gross income and gain from a pass-through business that is not otherwise subject to employment taxes. That means it would apply to S corporation shareholders who are active in the corporation's business, but don't receive a "sufficient" level of compensation. The proposal would also apply SECA tax to the distributive share of the business income that an S corporation shareholder receives who materially participates in the entity's business

Note: The proposal would also apply SECA tax (above a threshold amount) to the distributive shares of partners in limited partnerships and limited liability company (LLC) members that provide services to the entity and materially participate.

Conclusion

If the legislative proposal is enacted into law, it would significantly change the taxation of pass-through entities and owners that have AGI above the $400,000 threshold. The technique of reducing employment tax by managing compensation levels withing the boundaries set by the IRS and the courts would no longer be a viable strategy. Also, if enacted, the proposal could incentivize the revocation of the S election in favor of C corporate status. But, that move depends, at least in part, on where the C corporate tax rate turns out to be - that's under consideration in the Congress also.

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