

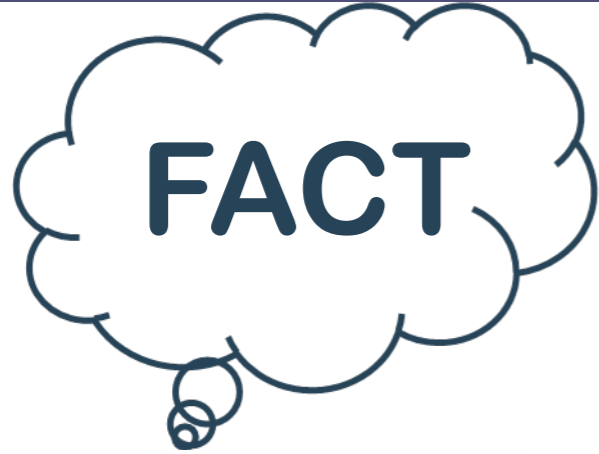
What's Reasonable?

Reasonable Compensation and Challenges by the IRS

Eric L. Green
Paul Hamann

TRN
TAX REP NETWORK

What is “Reasonable Compensation”?



Wages/Salary = Payroll Taxes

Distributions = No Payroll Taxes

**Substantial Services = Reasonable
Compensation**

The Tax Savings from Distributions

- ▶ S Corporations can create significant tax savings
- ▶ The lower the wages, the more taxes are reduced for FICA
- ▶ S Corporation elections can be done within 60 days prior to the year end or within 75 days after the year has begun (so 11/3/23 – 3/15/24)

Cases re Reasonable Compensation

- ▶ 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 (2003)**
- ▶ Joly v. Commissioner (2000)
- ▶ Spicer Accounting, Inc. v. United States (1990)
- ▶ Joseph Radtke, S.C. v. United States (1989)

Notes:

Cases in RED are Accounting firms

**Client of Joseph M. Gray

David E. Watson, P.C. v. United States:

- ▶ Mr. Watson's firm made distributions of its profits to Mr. Watson, a C.P.A., of over \$200,000 in 2002 and \$175,000 in 2003.
- ▶ Mr. Watson only paid himself compensation of \$24,000 for those same years.
- ▶ IRS audited Mr. Watson, and they determined that Mr. Watson's replacement cost would be just over \$91,000, so recharacterized \$67,000 of distributions per year to wages.
- ▶ Tax, penalties, and interest assessed was just over \$48,500.

David E. Watson, P.C. v. United States:

- ▶ Mr. Watson's position was that he had determined what his salary should be and the IRS didn't have the right to change it.
- ▶ The U.S. District Court for the Southern District of Iowa rejected Mr. Watson's claim that his self-determined salary was reasonable without credible research or documentation.
- ▶ Court ruled in favor of the IRS, emphasizing Mr. Watson's education, experience, dedication to the firm, and the services he provided.

Sean McAlary Ltd, Inc. v. Commissioner:

- ▶ Mr. McAlary was the shareholder of a real estate company who took significant profit distributions without paying himself any salary.
- ▶ Established a remuneration agreement whereby he would take a base salary of \$24,000 per year, with an additional \$10,000 for each broker he supervised on staff.
- ▶ McAlary's sales agents operated as independent contractors.
- ▶ Most of McAlary's gross receipts were attributable to sales commissions generated by Mr. McAlary, as opposed to McAlary's other sales agents.

Cases

- ▶ The IRS recalculated his wages based upon the company's gross receipts and net sales.
- ▶ The court concluded that Mr. McAlary's reasonable compensation should be \$83,200, basing it on the selected wage rate and hours worked.
- ▶ The court criticized Mr. McAlary's compensation agreement, which lacked an arm's length negotiation, and the IRS's flawed comparisons based on gross receipts and net sales.
- ▶ Reasonable compensation must be based upon multiple factors, including the shareholder employee's roles, experience, and industry standards.

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.” ~ Instructions 1120S
- ▶ “Reasonable compensation is the value that would ordinarily be paid for like services by like enterprises under like circumstances.”
 - ~ IRS Code: Section 162-7(b)(3)
- ▶ “Reasonable & Services Rendered”
 - ~IRS Code Section 162(a)(1), looks at Replacement Cost and Fair Market Value of the services being provided.

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.

Can't we just 1099 the owner for the
"reasonable comp" amount and make it
subject to SE Tax?

W-2 vs 1099

- ▶ Revenue Ruling 74-44:

 - ~ An officer of a corporation is considered an EMPLOYEE

- ▶ Employee or Independent Contractor

 - ~ Under common-law rules, anyone who performs services for you is your employee if you can control what will be done and how it will be done.

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

Services of the Shareholder

- ▶ In addition to the shareholder-employee direct generation of gross receipts, the shareholder-employee should also be compensated for administrative work performed
- ▶ It includes all services they perform
- ▶ What comparable businesses pay for similar services?

Factors Considered by the Courts

- ▶ Owner's 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

Reasonable Compensation

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

~ FS-2008-25

- ▶ Profitability has no bearing on reasonable comp

Profitability vs Distributions

- ▶ Assume Scott's Reasonable Compensation is \$68,000
- ▶ If Scott takes money out of the company, the first \$68,000 has to be wages, regardless of the company profits
- ▶ Assume in 2022 the Company profit was \$210,000
- ▶ Scott took \$200,000 out of the company
 - ~ \$68,000 is salary
 - ~ \$132,000 is distribution

Profitability vs Distributions

- ▶ Assume Scott's Reasonable Compensation is \$68,000
- ▶ Now, the 2022 profit was \$23,000
- ▶ Scott took \$30,000 out of the company
 - ~ \$30,000 is salary
 - ~ \$0 is distribution

Profitability vs Distributions

- ▶ Assume Scott's Reasonable Compensation is \$68,000
- ▶ Now, the 2022 profit was \$150,000
- ▶ Scott took \$0 out of the company
 - ~ \$0 is salary
 - ~ \$0 is distribution

Shareholder Loan or Capital Contribution

- ▶ ***Glass Blocks Unlimited v. Commissioner (2013):***
- ▶ In 2007, the owner Fredrick Blodgett had the following:
 - 2007 Company Net Income = \$877
 - 2007 Fredrick Transferred into the company \$45,000
 - 2007 Took out \$30,844
 - 2007 He took no salary
- ▶ Mr. Blodgett argued he made a loan and repaid himself

Shareholder Loan or Capital Contribution

IRS Position:

- ▶ Transfer in was a contribution to capital (basis)
- ▶ Transfer out was a distribution (Return of basis)
- ▶ Reasonable Compensation must be paid before a distribution can be made

Shareholder Loan or Capital Contribution

Decision: Transfer in was a contribution not a loan:

- ▶ No written agreement or promissory note
- ▶ No interest charged
- ▶ No security/collateral
- ▶ No fixed repayment schedule
- ▶ “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 or Capital Contribution

▶ Math works out this way:

▶ Net Income (before)	\$877	
▶ Wages	\$-30,844	(W-2 Income to Shareholder)
▶ Employment Taxes	\$-2,360	
▶ Penalty & Interest	<u>\$-1,923</u>	
▶ 2007 Net Loss (after)	<u>\$-34,250</u>	(K-1 Loss)

Davis v. US

- ▶ Mile High Calcium owned by Carol Davis, husband was an “officer”
- ▶ Assessed penalties and interest re reasonable compensation
- ▶ Able to show that husband Henry:
 - ~ Not an Employee, No Active Participation
 - ~ Worked for outside employers and Officer in name only

There is an exception for officers who perform only minor services... (Treas. Reg. § 31.3121(d)-(1)(b))

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- ▶ Taxable income of the taxpayer and spouse if filing married filing jointly
- ▶ Wages reported on Schedule C or from the flow through entity
- ▶ If multiple business have the businesses been aggregated.
- ▶ Taxable income from each of the businesses
- ▶ Guaranteed payments from partnerships
- ▶ Type of business
- ▶ Filing status
- ▶ Net capital gain
- ▶ Qualified cooperative dividends
- ▶ The basis in qualified property
- ▶ REIT dividends



"Chances are 50/50 that it's a total crapshoot, but it could go either way."

Questions

- ▶ Paul: phamann@rcreports.com
- ▶ Eric: egreen@gs-lawfirm.com

