

IRS Enforcement Against S Corporation Owners: What's Reasonable?



Who We Are



Paul S. Hamann

RCReports



Eric Green, Esq.

Green & Sklarz LLC

MYTHS VS. FACTS

REASONABLE
COMPENSATION
EDITION



Polling Question: Myth or Fact

Which of the following methods of determining Reasonable Compensation are recognized by the IRS:

- A. Industry Rule (Set wages as a percentage of sales or revenue based on industry standards)
- B. 50/50 Rule (50% distribution – 50% Wages)
- C. Safe Harbor Rule (Set wages at the S.S. Max)
- D. All the above
- E. None of the above

Polling Question: Myth or Fact

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- ~~B. 50/50 Rule (50% distribution – 50% Wages)~~
- ~~C. Safe Harbor Rule (Set wages at the S.S. Max)~~
- ~~D. All the above~~
- E. None of the above**

In the last year, we've asked
100,000+ Tax Advisors
this question.

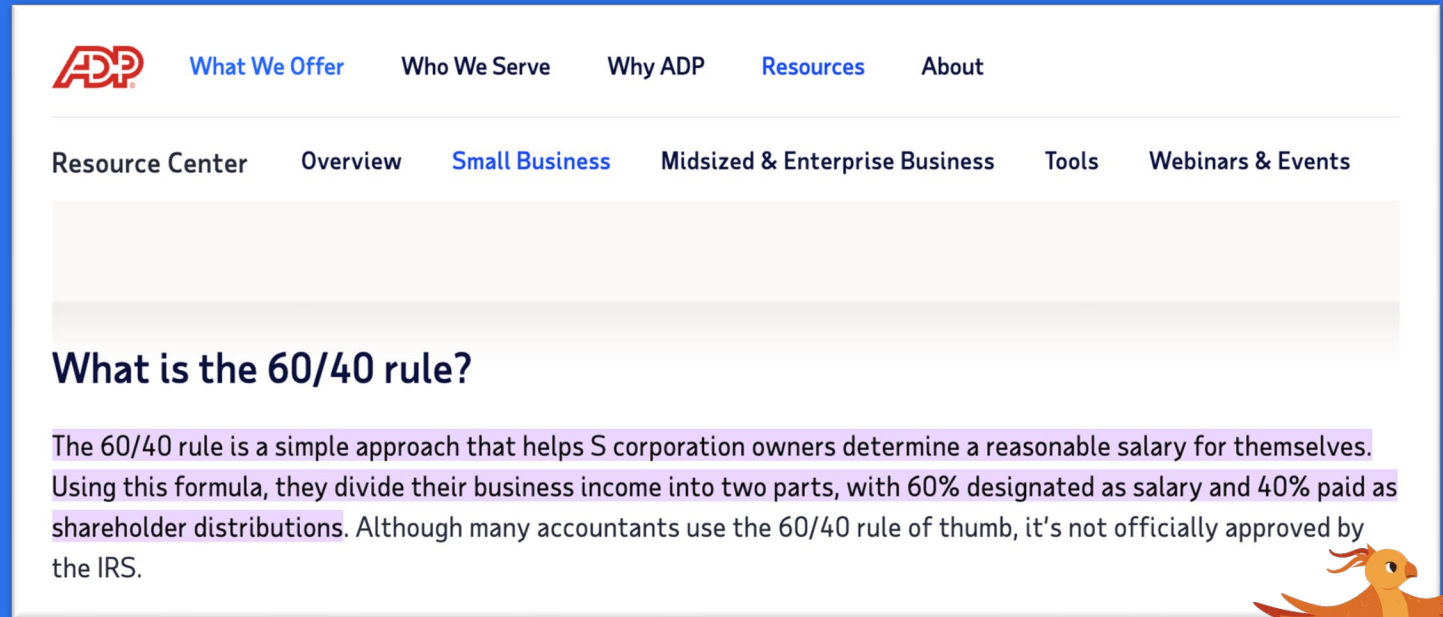


73% believe at least one myth.



Myth: 60/40 Rule or 50/50 Rule

"The 60/40 rule is a simple approach that helps S corporation owners determine a reasonable salary for themselves. Using this formula, they divide their business income into two parts, with 60% designated as salary and 40% paid as shareholder distributions."



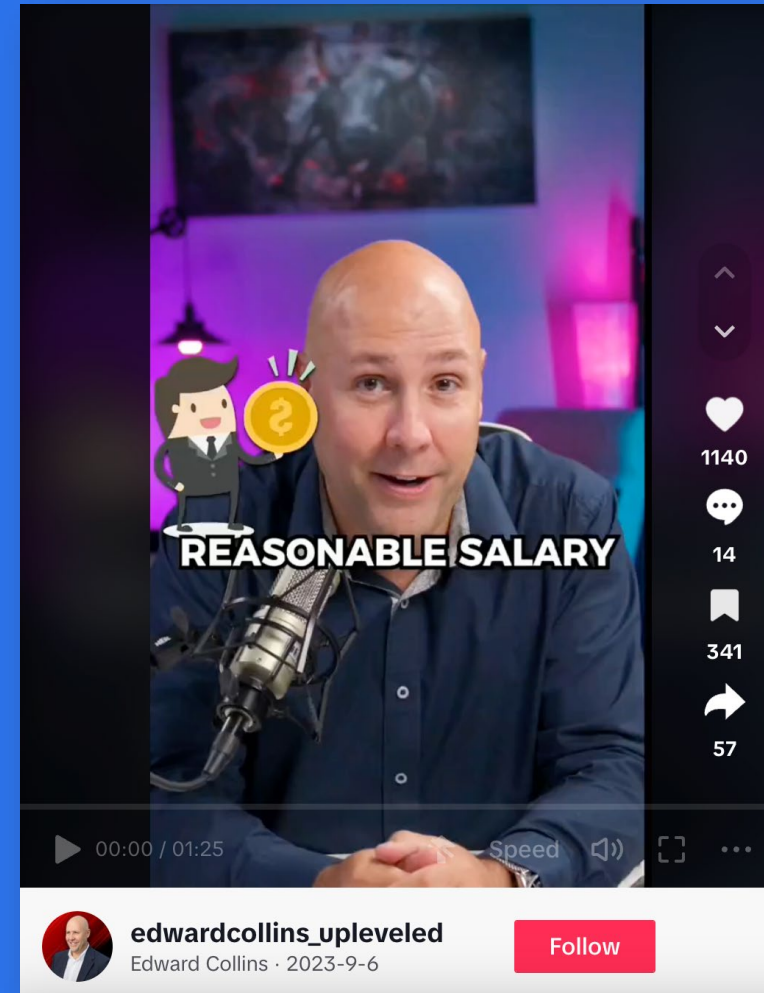
The screenshot shows the ADP website's navigation menu with links for 'What We Offer', 'Who We Serve', 'Why ADP', 'Resources', and 'About'. Below this is a secondary menu with 'Resource Center', 'Overview', 'Small Business', 'Midsized & Enterprise Business', 'Tools', and 'Webinars & Events'. The main content area features the heading 'What is the 60/40 rule?' followed by a paragraph: 'The 60/40 rule is a simple approach that helps S corporation owners determine a reasonable salary for themselves. Using this formula, they divide their business income into two parts, with 60% designated as salary and 40% paid as shareholder distributions. Although many accountants use the 60/40 rule of thumb, it's not officially approved by the IRS.'



Myth: Industry Rule

Set wages as a percentage of sales or revenue based on industry standards

"That reasonable salary can be anywhere from 30-50% of the net income from your business."



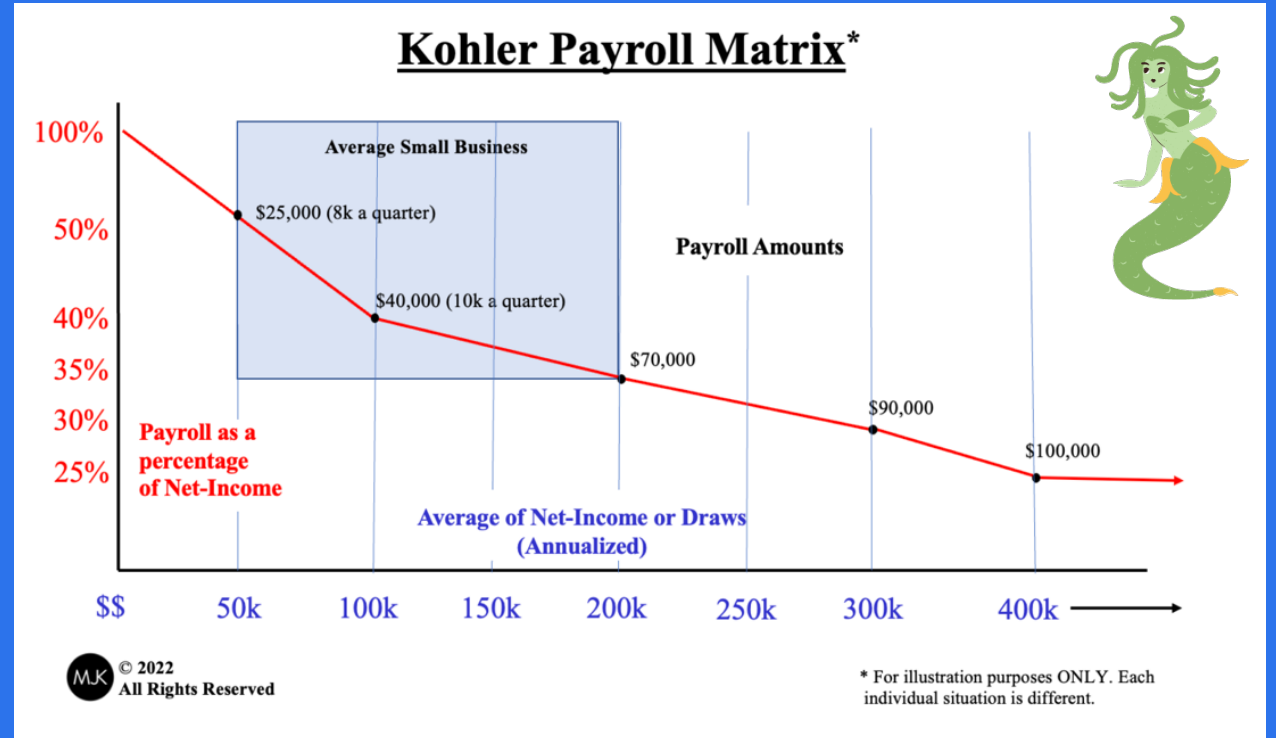
Myth: Industry Rule

Payroll as a percentage of
Net-Income

“
I have never ever had a client
audited for taking too little in
payroll.”

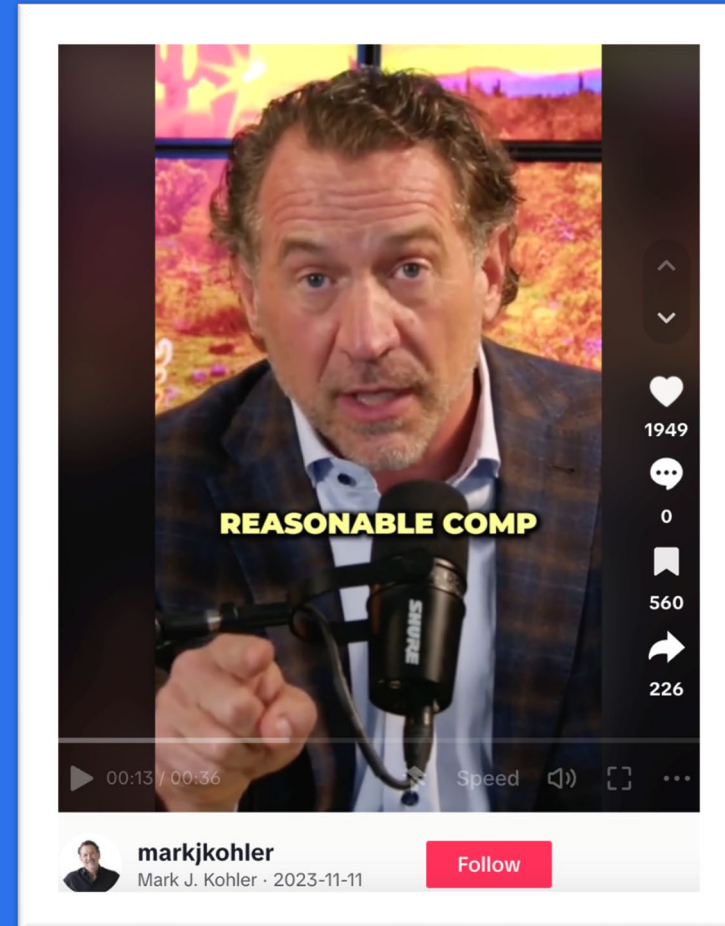


Mark J. Kohler ✓
@markkohler



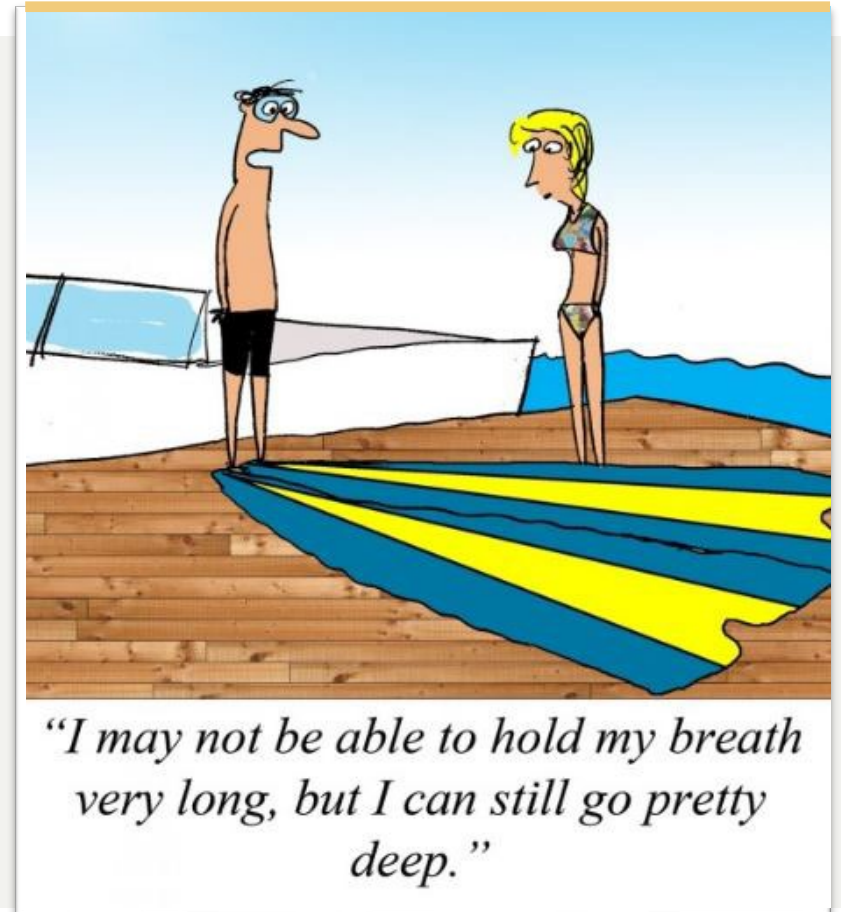
Myths: Wild A** Guess

"Save employment taxes by setting up your consulting business as an S-Corp. At the lower end you get to decide a fair wage to pay yourself and save social security taxes."



Agenda

- Advantage Distribution V. Wages
- Reasonable Compensation in the courts
- IRS Guidelines
- Profitability V. Distributions
- Reasonable Compensation and the IRS
- Determining Reasonable Compensation
- Tips, Advice, Q&A



Big Changes

IRS Launches Study of S Corporation Reporting Compliance



IR-2005-76, July 25, 2005

WASHINGTON — Internal Revenue Service officials announced today the launch of a study to assess the reporting compliance of S corporations. The study, carried out under the National Research Program (NRP), will examine 5,000 randomly selected S corporation returns from tax years 2003 and 2004.

Terms

Shareholder-employee (SE)

- = Corporate officer
- = S Corp owner

Reasonable Compensation

- = Replacement Cost  
- = Fair Market Value (FMV)  

Distributions

- = Dividends
- = Loan repayment, Return of basis





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Reasonable Compensation: Replacement Cost



RC Reports



Reasonable Compensation: Fair Market Value



Advantage of Distributions over Wages



“Since this is our first deep dive, maybe we should save the Marianas Trench until we have more experience.”

Distribution vs Wages/Salary

Wages/Salary

=

Payroll Taxes

Distributions

≠

Payroll Taxes

Substantial Services

=

Reasonable Compensation

S Corp Advantage

Example 1:

All Profit taken
as Wages



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Entity: *Stone Concrete, Inc.*

Owner/SH *Scott Stone*

Net Income: \$100,000

Reasonable Comp/Wages: \$100,000

All Profit/Income 1040 → **W-2**

S Corp Advantage

Example 1: Scott & Stone Concrete responsible for
Payroll Taxes 15.3% on **\$100,000**

7.65% Stone Concrete SS/Medicare = \$7,650

7.65% Scott Stone SS/Medicare = \$7,650

Total Payroll Tax Liability = \$15,300

S Corp Advantage

Example 2:

All Profit taken
as Distribution



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Entity: *Stone Concrete, Inc.*

Owner/SH *Scott Stone*

Net Income: \$100,000

Reasonable Comp/Wages: \$0

All Profit/Income 1040 → **1120-S**

S Corp Advantage

Example 2: Scott & Stone Concrete responsible for
Payroll Taxes 15.3% on \$0

7.65% Stone Concrete SS/Medicare = \$0

7.65% Scott Stone SS/Medicare = \$0

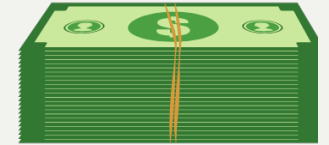
Income Tax [Return of Basis] = \$0

Total Payroll Tax Liability = \$0

Net tax savings = \$15,300

Distribution vs Wages/Salary

Wages/Salary :



: Distributions

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

S Corp Advantage

Example 3:

Scott Takes
Reasonable
Compensation



© RCReports All Rights Reserved

Entity: *Stone Concrete, Inc.*

Owner/SH *Scott Stone*

Net Income: \$100,000

Reasonable Comp/Wages: \$69,000

W-2 Wages \longrightarrow \$69,000

Distribution \longrightarrow \$31,000

S Corp Advantage

Example 3: Scott and Stone Concrete responsible for
Payroll Taxes 15.3% on **\$69,000**

7.65% Stone Concrete SS/Medicare =	\$5,278.50
7.65% Scott Stone SS/Medicare =	\$5,278.50
Total Payroll Tax Liability =	\$10,557
Net tax savings =	\$4,743

Reasonable Compensation in the Courts



"It's agreed. Our new business will be called Three Dogs And A Squeeze Toy."

Reasonable Compensation in Courts

IRS 25-1*



VS



Reasonable Compensation in Courts

David E. Watson, P.C., V. United States of America (2010)



VS



Reasonable Compensation in Courts

Low Salary V. Profit Distributions

2002

Profit Distributions = \$203,651

Salary = \$24,000

2003

Profit Distributions = \$175,470

Salary = \$24,000

Reasonable Compensation in Courts

IRS Objected

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



Reasonable Compensation in Courts

IRS Audit 2007



Reasonable Compensation in Courts

Reasonable Compensation

2002

\$91,044

2003

\$91,044

Reasonable Compensation in 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 Courts

\$48,521

Owed in tax penalties and interest

Whereas original tax would have been \$20,000

Reasonable Compensation in Courts

Watson V. IRS



VS



Reasonable Compensation in Courts

Ruling in favor of IRS 2010



VS



Reasonable Compensation in Courts

IRS Objections

Watson's Background:

- **Education:** Graduate Degree
- **Experience:** 20 Years
- **Time:** Full Time

Many Hats

Various Job Duties:

- CPA/Accountant
- Partner
- Re-structured businesses



No Research and No Documentation

Reasonable Compensation in Courts

Appealed



Reasonable Compensation in Courts

Upheld District Courts Ruling 2012



VS



Reasonable Compensation in Courts

Appealed Denied



Take Aways

- Reasonable Reimbursement for Services Performed
- Paid Some RC
- IRS did not recharacterize all distributions
- Single Shareholder
- Services only

Reasonable Compensation in Courts

Sean McAlary LTD, Inc. V. Commissioner (IRS) (2013)



VS



Reasonable Compensation in Courts

McAlary Ltd = Real Estate Company


- 2006 Net Income = \$231,454
- 2006 Distribution = \$240,000
- 2006 Salary = Zero



Reasonable Compensation in Courts

McAlary Ltd

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 Courts

McAlary Ltd

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 Courts

IRS Calculation: \$100,755 = \$48.44 x 2,080

- 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 Courts

McAlary Calculation: \$24,000


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



Reasonable Compensation in Courts

McAlary Ltd

Court Calculation: \$83,200

- Various Services 
- Wage Range
- Hourly Wage = \$40.00
- $2,080 \times \$40.00 = \$83,200$




Reasonable Compensation in Courts


McAlary Ltd

Court Calculation: \$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 Courts


McAlary Ltd

Court Calculation: \$83,200



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Reasonable Compensation in Courts

McAlary Ltd

Court Calculation: \$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.

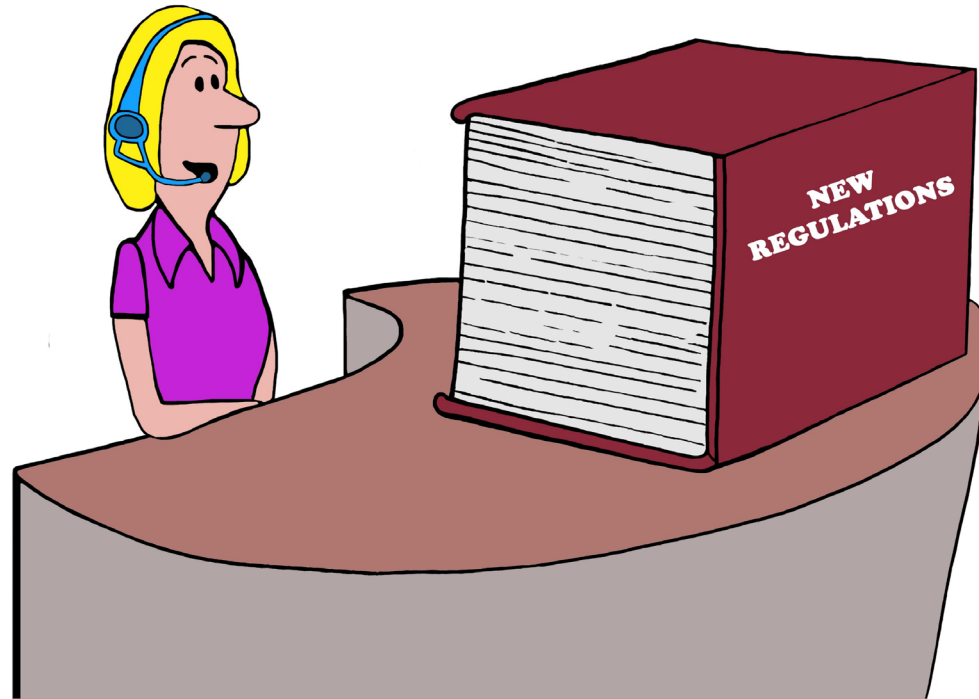
Reasonable Compensation in Courts

Court Rulings

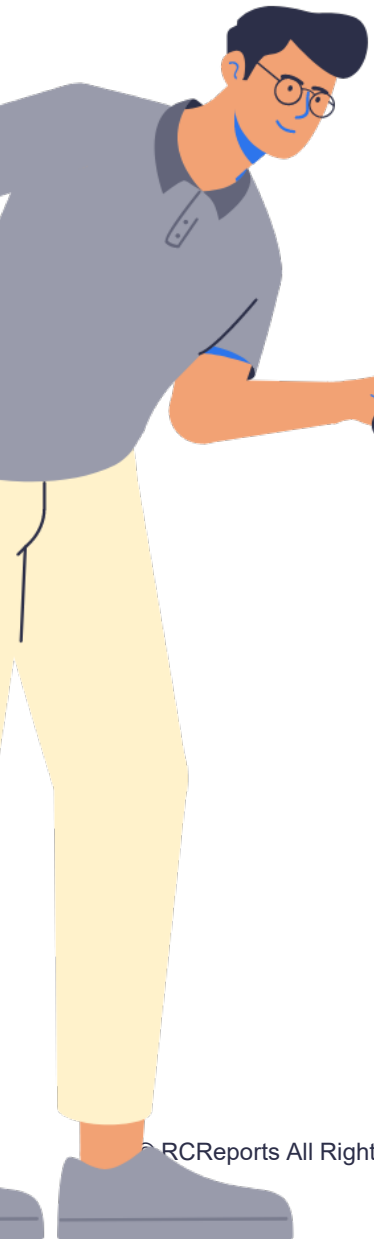
- Sean McAlary Ltd, Inc. v. Commissioner 2013
- Glass Blocks Unlimited v. Commissioner 2013
- Patrick & Suzanne Herbert v. Commissioner 2012
- David E. Watson, P.C. v. United States 2010
- JD & Associates, LTD v. United States 2006
- Joseph M. Grey Public Accountant, P.C. v. Commissioner 2002**
- Veterinary Surgical Consultants,P.C. v. Commissioner 2003**
- Joly v. Commissioner 2000
- Spicer Accounting, Inc. v. United States 1990
- Joseph Radtke, S.C. v. United States,1989

Cases in orange are accounting firms
** Clients of Joseph M. Gray

IRS Guidelines



“Give me a couple years, and I can answer your simple question about the new regulations.”



What is Reasonable Compensation?

IRS Code: *Section 162-7(b)(3) Reasonable compensation is the value that would ordinarily be paid for like services by like enterprises under like circumstances*

Section 162(a)(1) Reasonable & Services Rendered

As a question: How much compensation would be paid for this same position, held by a non-owner in an arm's-length employment relationship, at a similar company?

Valuation: The hypothetical replacement cost of an owner or key manager of a business.

IRS Guidelines – CP261: Acceptance S Corp Election

Department of Treasury
Internal Revenue Service
Ogden UT 84201-0038

ABC COMPANY
22 BOULDER STREET
HANSON, CT 00000-7253

We've accepted your S Corporation election
**You will be treated as an S Corporation starting
January 1, 2017**

Notice CP261
Notice date May 23, 2018
Employer ID number 99-9999999
To contact us Phone 800-xxx-xxxx
Page 1 of 3

Keep in mind

Payments to shareholder-employees for services rendered:

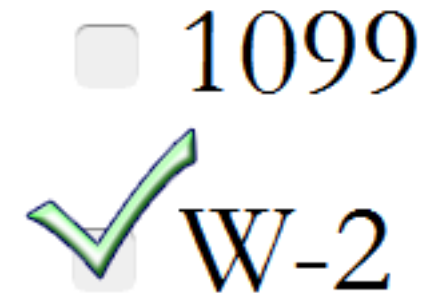
- You must determine a reasonable salary when a shareholder-employee of an S corporation provides services to the corporation.
- Payments to a shareholder-employee for services provided to an S corporation are wages and are subject to employment taxes.
- We may re-characterize distributions paid to a shareholder as salary if the distribution was paid in lieu of reasonable compensation (Revenue Ruling 74-44).

Payments to shareholder-employees for services rendered:

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IRS Guidelines

W-2 or 1099



- Revenue Ruling 74-44; IRC § states:
 - 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**



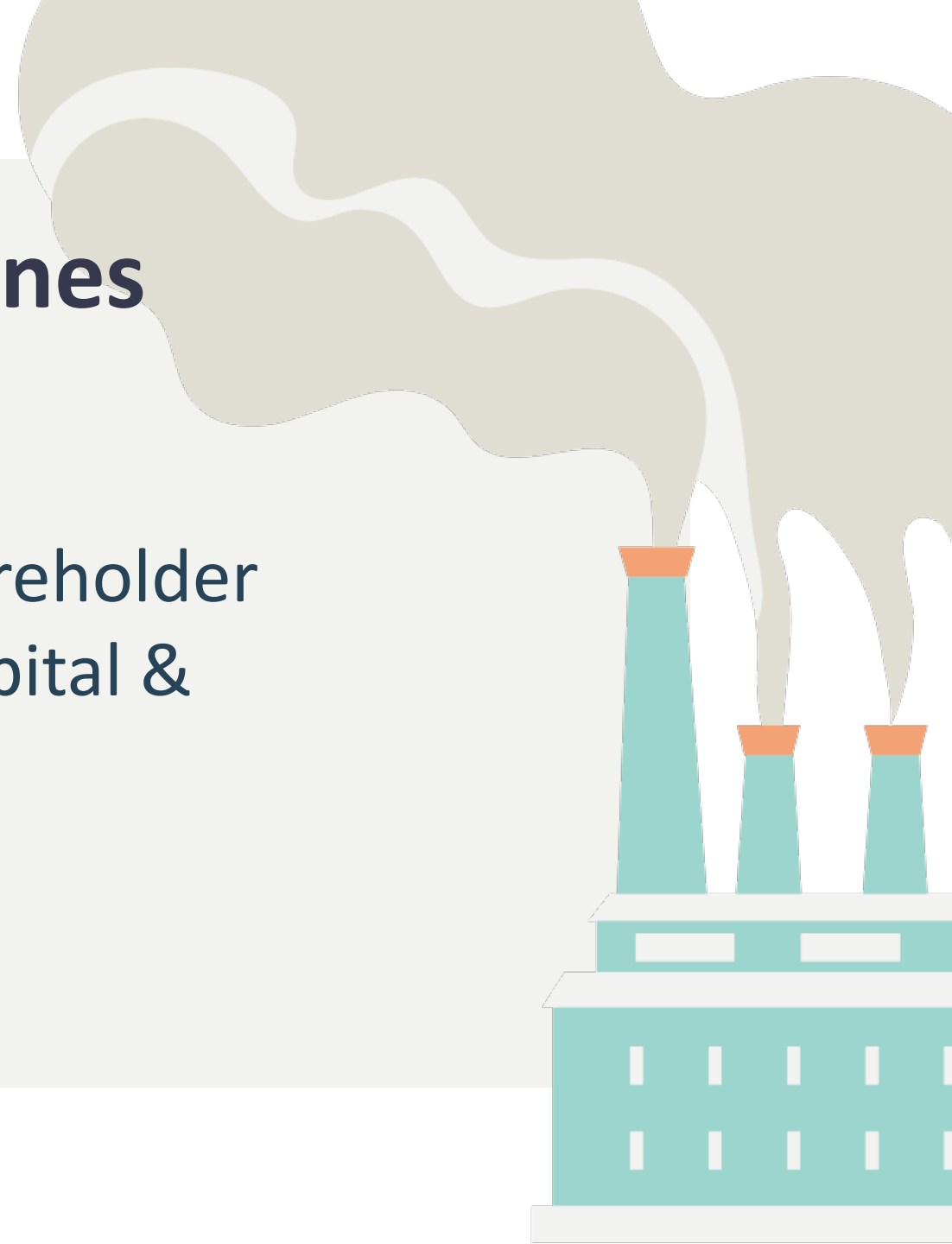
IRS Guidelines

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

IRS Guidelines

Services of non-shareholder
employees, or Capital &
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

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 to shareholders.

IRS Guidelines

Some factors considered by the courts in determining reasonable compensation:

- 1 • Training and experience
- 2 • Duties and responsibilities
- 3 • 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

1. Training and experience



&



IRS Guidelines

2. Duties and responsibilities



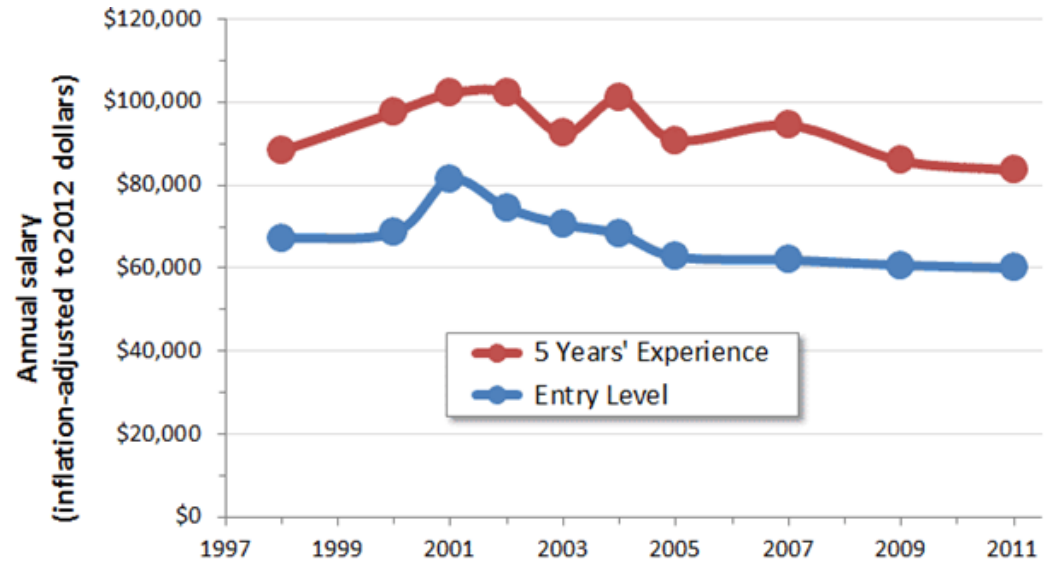
IRS Guidelines

3. Time and effort devoted to the business



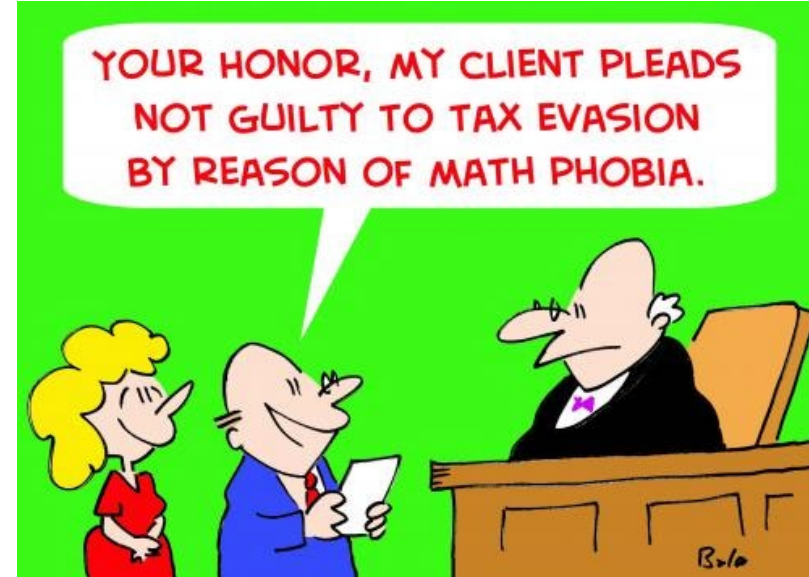
IRS Guidelines

4. What comparable businesses pay for similar services



IRS Guidelines

5. The use of a formula to determine compensation



IRS Guidelines

6. Payments to non-shareholder employees



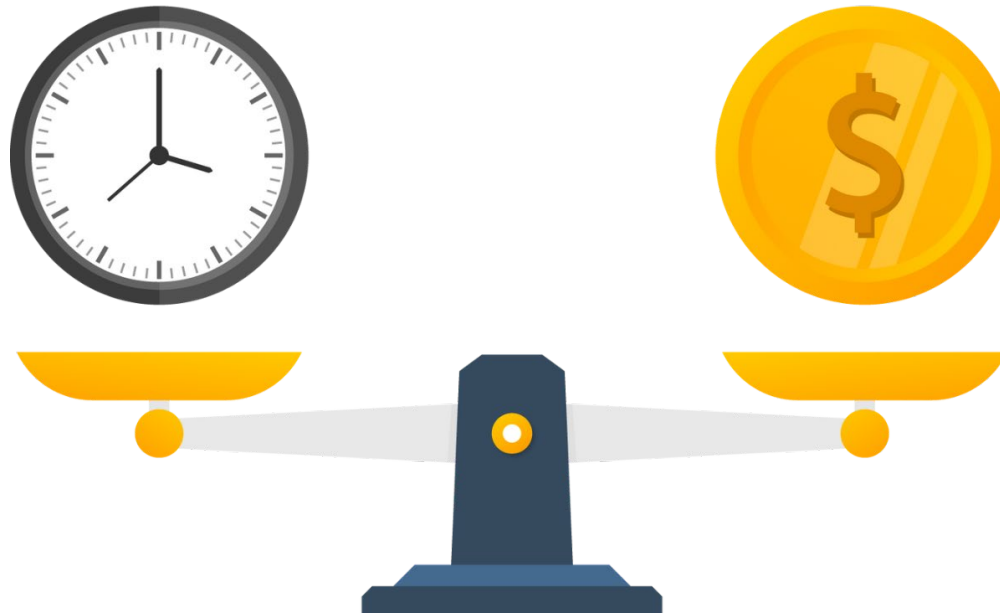
IRS Guidelines

7. Compensation agreements



IRS Guidelines

8. Timing and manner of paying bonuses to key people

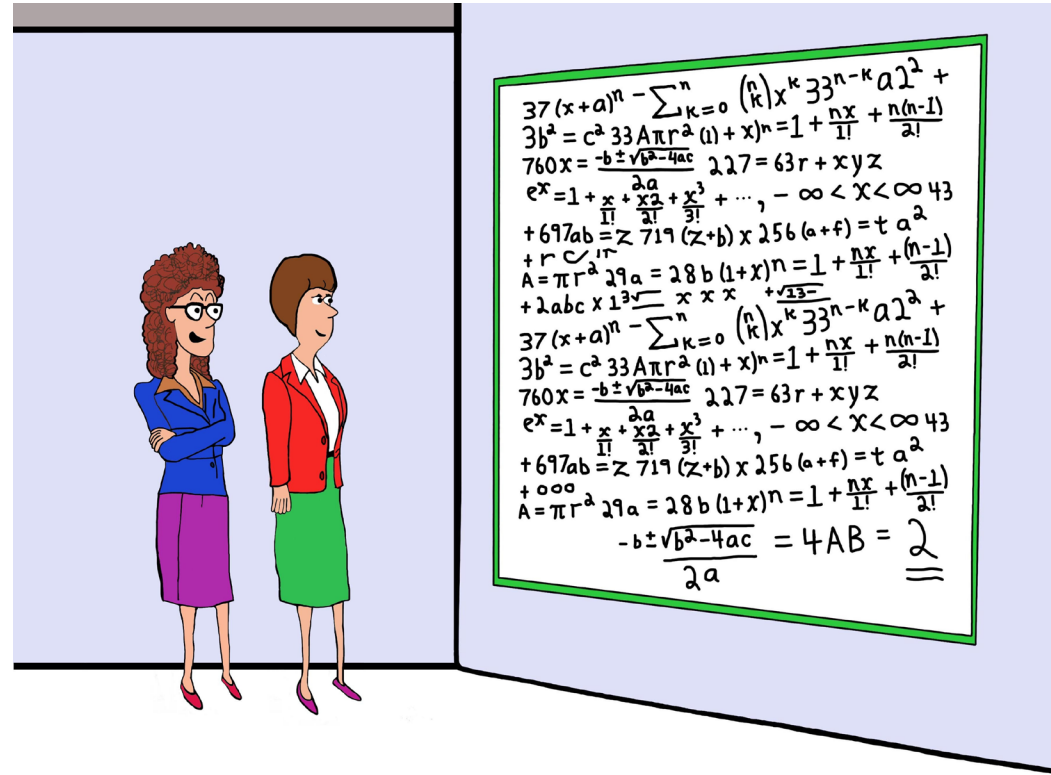


IRS Guidelines

9. Dividend history

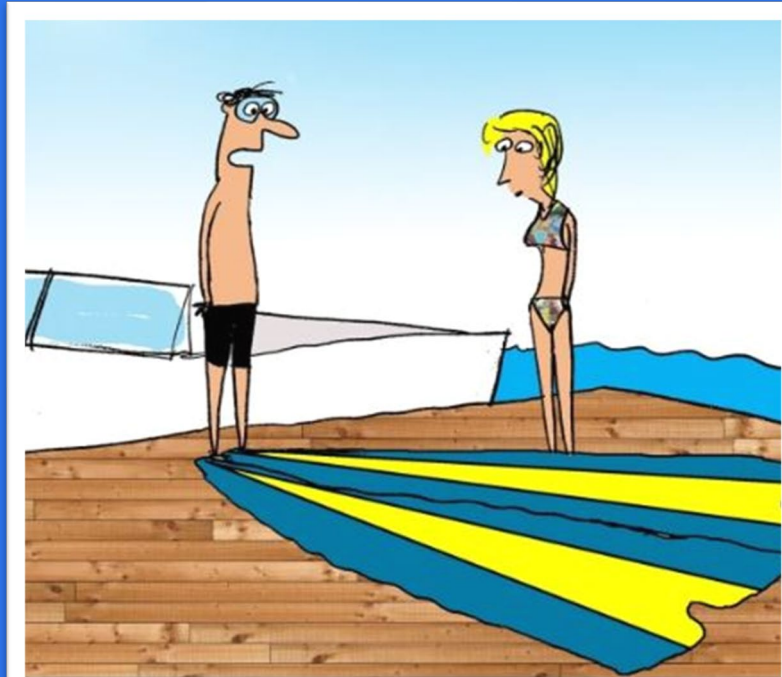


Distributions



“This is the most straightforward tax plan I’ve ever seen.”

Profitability v. Distributions



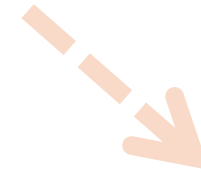
"I may not be able to hold my breath very long, but I can still go pretty deep."

Profitability v. Distributions

Reasonable Compensation



Distributions



Profitability

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

~ FS-2008-25



Profitability v. Distributions

Example 1: Scott Stone 100% of Stone Concrete (S Corp)

Scott's RC figure =	\$68,788
Stone Concrete Net Profit =	\$210,000
Scott takes \$200,000 out of Stone Concrete	
Scott receives wages (RC) of	\$68,788
Scott receives a distribution of	<u>\$131,212</u>
	\$200,000

Profitability v. Distributions

Example 2: Scott Stone 100% of Stone Concrete (S Corp)

Scott's RC figure =	\$68,788
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	<u>\$ 0</u>
	\$30,000

Profitability v. Distributions

Example 3: Scott Stone 100% of Stone Concrete (S Corp)

Scott's RC figure =	\$68,788
Stone Concrete Net Profit =	\$150,000
Scott takes \$0 out of Stone Concrete	
Scott receives wages (RC) of	\$ 0
Scott receives a distribution of	<u>\$ 0</u>
	\$ 0

Profitability V. Distributions

Example 4 Scott Stone 100% of Stone Concrete (S Corp)

	Year 1	Year 2	Year 3	Total
Scott RC	\$70k	\$70k	\$70k	\$210k
Net Profit	\$150k	\$175k	\$200k	\$525k
Scott Takes	\$0	\$0	\$500k	
Wages	\$0	\$0	\$210k	
Distribution	\$0	\$0	\$290k	

Profitability V. Distributions

Payroll Tax Savings – Example 4

	Year 1	Year 2	Year 3		Years 1-3
Reasonable Compensation	\$70,000	\$70,000	\$70,000		\$210,000
FICA 12.4% (2024 limit 168,600)	\$8,680	\$8,680	\$8,680		\$20,906
Medicare 2.9% (all)	\$2,030	\$2,030	\$2,030		\$6,090
Medicare Surtax 0.9% (over \$200K)	\$0	\$0	\$0		\$90
	\$10,710	\$10,710	\$10,710		\$27,086
			Total	\$32,130	
				-\$27,086	
			Tax Savings	\$5,044	

Advanced Court Cases



Shareholder Loan or Capital Contribution

GLASS BLOCKS UNLIMITED v. COMMISSIONER (IRS) (2013)



VS



Shareholder Loan or Capital Contribution

Glass Blocks Unlimited – Fredrick Blodgett

- 2007 Net Income = \$877
- 2007 Transferred in = \$45,000
- 2007 Transferred out = \$30,844
- 2007 Salary = Zero



Shareholder Loan or Capital Contribution

Glass Blocks Unlimited – Fredrick Blodgett

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

Glass Blocks Unlimited – Fredrick Blodgett

Glass Blocks Position

- Transfer in was a shareholder loan to GBU
- Transfer out was a repayment of the shareholder loan
- Reasonable Compensation does not apply



Shareholder Loan or Capital Contribution

Glass Blocks Unlimited – Fredrick Blodgett

Court Finding

Transfers in question were capital contributions and not bona fide loans

- No Written Agreements or Promissory notes
- No interest charged
- No security (collateral)
- No fixed repayment schedule



Shareholder Loan or Capital Contribution

Glass Blocks Unlimited – Fredrick Blodgett

Court Finding

“ 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

Glass Blocks Unlimited – Fredrick Blodgett

Court Finding - Math

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

Did the IRS Really Lose?

DAVIS v. UNITED STATES (1994)



VS



Did the IRS Really Lose?

Davis v. United States

Mile High Calcium Owned by:

- Carol L. Davis
- Henry Adams (husband)
- Transfers In and Out 1987-1989
- Assessed Taxes + Interest & Penalties of \$39,220



Did the IRS Really Lose?

Davis v. United States

Henry Adams – President

- Not an Employee
- No Active Participation
- Worked for outside employers
- Officer in name only
- There is an exception for officers who perform only minor services... (Treas. Reg. § 31.3121(d)-(1)(b))



Did the IRS Really Lose?

Davis v. United States

Carol L. Davis

- Was an Employee
- 12 hours per month (2.77 per week)
- \$8.00 per hour
- ~~\$39,220~~.....\$647



Reasonable Compensation & the IRS

Form 1125-E

- 2011 Required for Gross Revenue 500k+
 - Collecting data for future comparisons
- Disclosure Standards
 - Dollar Amounts must be verifiable
 - Taxpayer must be able to demonstrate the origin of the amount claimed
 - Taxpayer must be able to show he entered the amount in good faith

Form 1125-E only if total receipts are \$500,000 or more. See instructions for definition of total receipts.

(a) Name of officer	(b) Social security number (see instructions)	(c) Percent of time devoted to business	Percent of stock owned		(f) Amount of compensation
			(d) Common	(e) Preferred	
		%	%	%	
		%	%	%	

What's the IRS up to



Trixie's last hope was a job with the circus.

Reasonable Compensation & the IRS

1917 First time Reasonable Comp appeared at the IRS

- Joly v. Commissioner 2000
 - Established authority to reclassify distributions as wages
- Joseph M. Grey Public Accountant, P.C. 2002 & Veterinary Surgical Consultants, P.C. vs. Commissioner 2001
 - Reinforced employment status of shareholders as employees
- JD & Associates, LTD v. United States 2006
 - Shareholder bears the burden of demonstrating the compensation paid was reasonable
- David Watson, PC v. United States 2012
 - Reasonable Reimbursement for Services Performed

Reasonable Compensation & the IRS

TIGTA 7-2002: The IRS does not always address S Corp officer compensation during examination

Average W-2 Wages \$5,300

Average Distribution \$349,323

IRS Launches Study of S Corporation Reporting Compliance



IR-2005-76, July 25, 2005

WASHINGTON — Internal Revenue Service officials announced today the launch of a study to assess the reporting compliance of S corporations. The study, carried out under the National Research Program (NRP), will examine 5,000 randomly selected S corporation returns from tax years 2003 and 2004.

Reasonable Compensation & the IRS

Inflation Reduction Act of 2022 (IRA22)



2022

IRS Receives \$45.6
Billion



2023

IRS begins to Hire
& Train 87,000 new
agents



2024

Newly trained
agents begin
working cases

What to Know

IRS hired and trained new work force

A bar chart with 15 vertical bars of increasing height from left to right. A dark blue arrow curves upwards and to the right, starting from the top of the first bar and ending above the last bar. The chart is set against a white background with a thin black border.

Reasonable Compensation Cases

More Challenges This Year
Than any Other in Our History

Reasonable Compensation & the IRS

2023 PayrollOrg Congress

Paul Mamo

Assistant Deputy Commissioner for Services &
Enforcement

Dan Lauer

Director of SB/SE,
Examinations and Specialty Tax

SB/SE will be focusing on: Payroll Compliance [940 & 941]

- ERC Fraud Initiative
- **S Corp Audits: Assessing if S Corp owners receive Reasonable Compensation**
- Worker Classification Audits: 1099 v. W-2



Being Right Isn't Enough

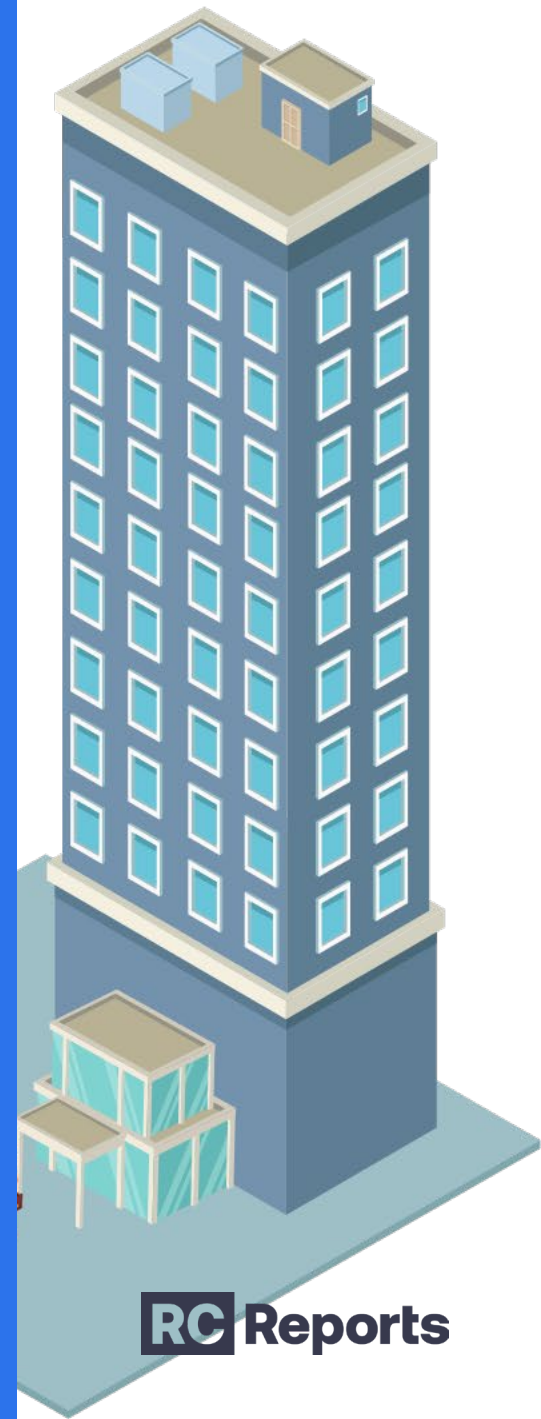
Background of the S Corp

Tax Year Under Audit = 2022

HR outsourcing company

\$30M Top Line Revenue

\$3M Adjusted Gross Profit

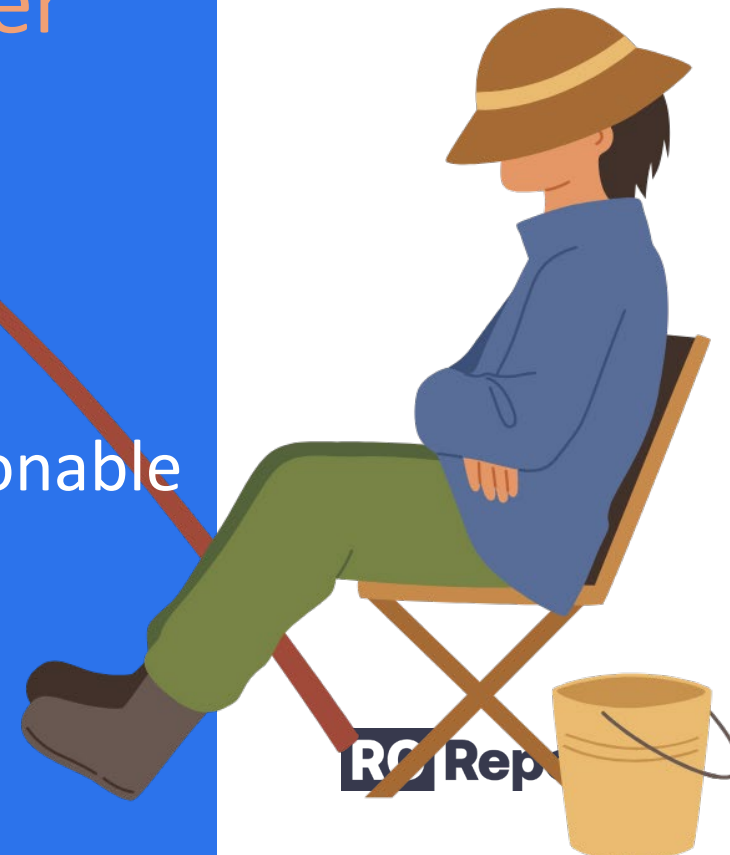




Being Right Isn't Enough

Background of the Shareholder

High Distributions
Low Reasonable Compensation
No Supporting Documentation for Reasonable Compensation



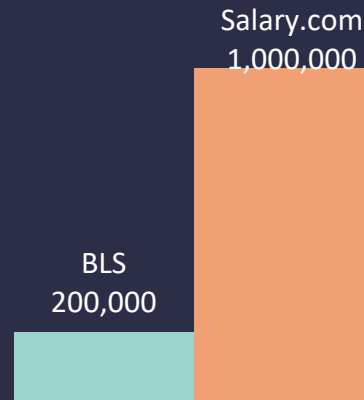


What The IRS is Saying

Triggered via Payroll Audit
[940/941] Part of SB/SE



Based RC on CEO of Similar
Size Company



Referenced JD & Associated v.
IRS



What the Taxpayer's Representative is Saying

TRN

Accurately defined
Shareholders Role



Directed Examiner to IRS
Guidelines on Gross Receipts
and Profits



Referenced Davis v. IRS



Being Right Isn't Enough



Anticipated Outcome

- Reasonable Compensation Paid \approx **\$70k**
- RCReports Conclusion \approx **\$63k**
- No Change Letter
- Likely not challenged for following year



Big Trouble

Background of the S Corp and Shareholder

- Tax Year: 2020
- Personal Shopper and Delivery Service
 - Single Shareholder
- Zero Reasonable Compensation Paid
 - Distributions of \approx 45k Received



What The IRS is Saying

Triggered via Payroll Audit
[940/941] Part of SB/SE



Increase reasonable compensation
figure pushed higher



WHY?!



Big Trouble

So WHY?!



Big Trouble



The Cost of Getting Caught

- $45,000 \times 15.3\% = \$6,885$
- Plus Penalties & Interest
- 2.5 times tax owed $\approx \$20,000$

Big Trouble

Crystal Ball Outcome



Best Case Scenario

- Reasonable Compensation Baseline at **\$45,000**
- Taxes Penalty & Interest
 - 2020 ≈ **\$20,000**
 - 2021 ≈ **\$20,000**
 - 2022 ≈ **\$20,000**
- Total **\$60,000**
- NO Paid Preparer Penalty

Big Trouble

Crystal Ball Outcome



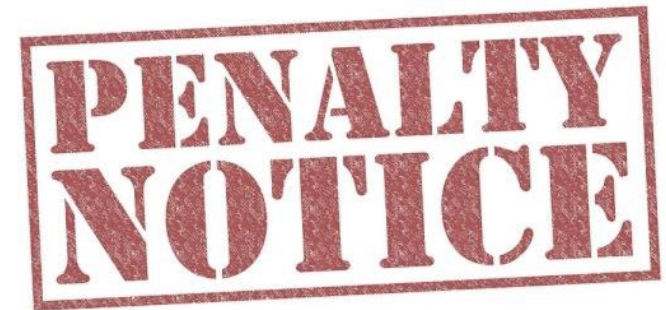
Worst Case Scenario

- Reasonable Compensation Pushed Higher **\$90,000**
- Taxes Penalty & Interest
 - 2020 ≈ **\$20,000**
 - 2021 ≈ **\$35,000**
 - 2022 ≈ **\$35,000**
- Total **\$90,000**
- Paid Preparer Penalty $\$5,000 \times 3 =$ **\$15,000**
- Examiner looks at Preparers other clients

Reasonable Compensation & the IRS

Preparer Penalties \$5,000 IRC sec. 6694(b)

- IRS does expect preparers to have appropriate checklists
- IRS does not expect the preparer to merely accept the information
- IRS does require the preparer to be proactive
- Penalties can and will be imposed on preparers



Burden of Proof IRC sec. 7491



RC Challenged → the taxpayer has the
“Burden of Proof”

[CP261 and J.D. & Associates v. U.S.]

Burden of Proof shifts to the IRS if:

- Taxpayer introduces Credible Evidence
- Taxpayer has kept Records that meet IRS requirements

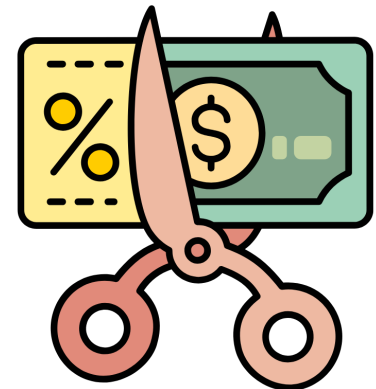
Reasonable Compensation & the IRS

No Tax Court for Reasonable Compensation 2017

Notice of Employment Tax Determination under IRC §7436 - Additional Compensation to Officer Employees

Not Issue Letter 3523: Notice of Determination of Worker Classification

- Cannot proceed to Tax Court
- Pay Tax
- Sue for refund

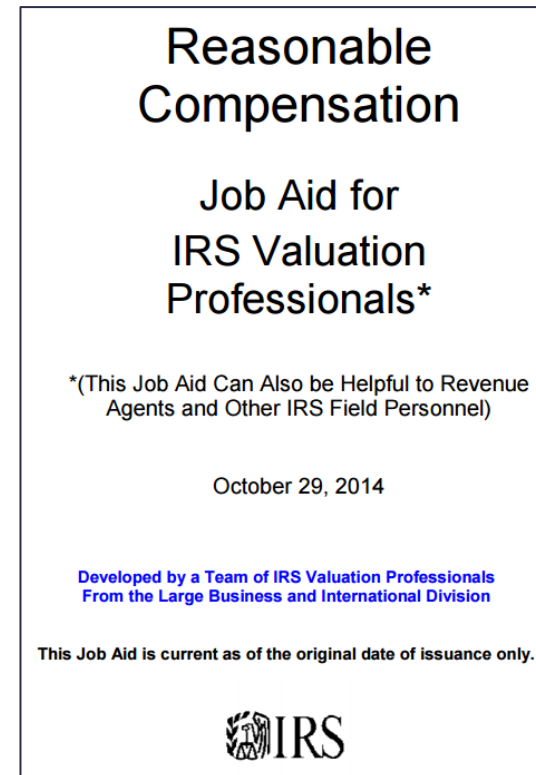


Approaches for Determining RC



Reasonable Compensation Job Aid for IRS Valuation Professionals

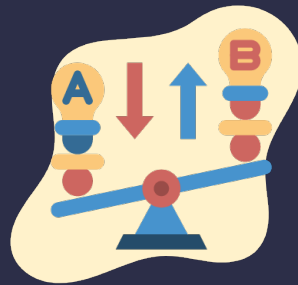
Companies have the burden of showing
that compensation is reasonable



How to Determine Reasonable Compensation



THE COST APPROACH
Many Hats Approach



THE MARKET APPROACH
Industry Comparison Approach



THE INCOME APPROACH
Independent Investors Approach

How – Cost Approach

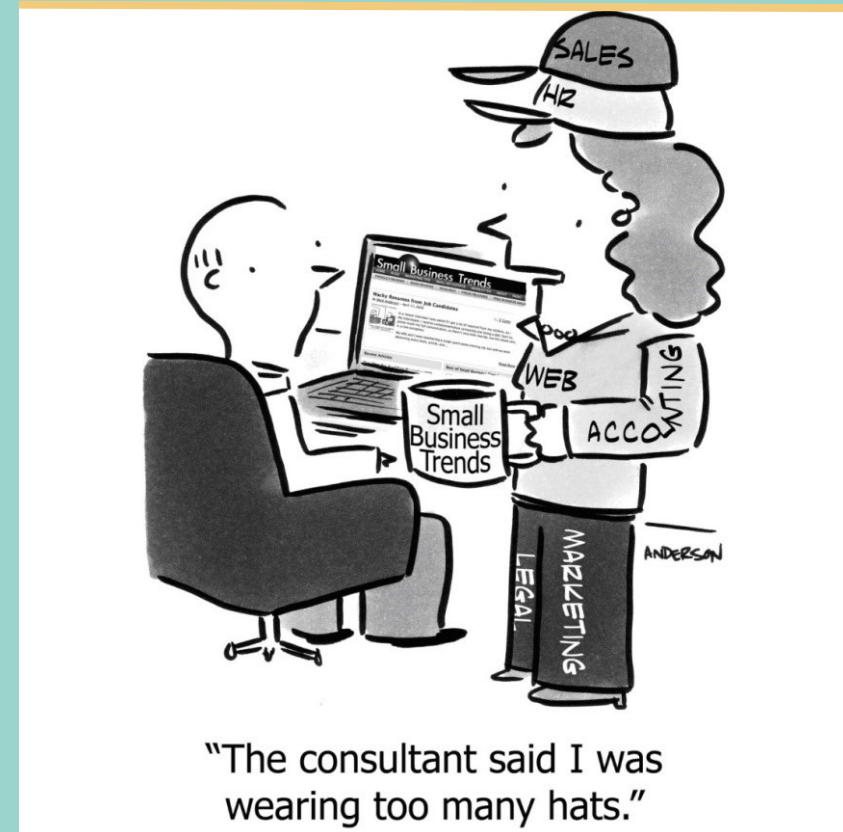
AKA Many Hats Approach



	D	E	F	G
Materials Cost Estimate Luis Cedillo per#6				
Size/Description	Quantity	Unit	Cost	Cost
Cubic yard	2.5		\$75.00	\$187.50
#4 (1/2in. X 10ft)	20		\$4.47	\$89.40
2in. x 4in. - 12ft	2		\$11.31	\$22.62
2in. x 4in. - 16ft	2		\$14.95	\$29.90
2in. x 4in. - 32 5/8in.	45		\$3.10	\$139.50
2in. x 4in. - 8ft	16		\$3.06	\$48.96
2in. x 4in. - 8ft	15		\$3.06	\$45.90
2in. x 4in. - 8ft	8		\$3.06	\$24.48
2in. x 6in. - 8ft	6		\$4.20	\$25.20
1/2in. x 4ft x 8ft sheet	15		\$6.85	\$102.75
8ft x 150ft	1		\$98.00	\$98.00
Bundle of 200 sq. ft	3		\$300.00	\$900.00
1/2in. x 4ft x 8ft sheet	15		\$6.85	\$102.75
Gallon (400 sq. ft per gallon)	2 coats		\$15.99	\$47.97
3.5in. x 15in. - 40 sq. ft	3		\$8.48	\$25.44
1/2in. x 6in.	14		\$0.42	\$5.88
24in. x 36in.	2		\$134.00	\$268.00
Double - 7ft x 80in.	1		\$250.00	\$250.00

How – Cost Approach

- All Tasks Performed
- Apportion Time
- Skill-Proficiency
- Comparability Data
- Small Business



Scott Stone at 25

How many hours do you work per week on average? 40+				
State your business is located Illinois				
County or township your business is located Cook				
Yes/No	Title	Definition	Time %	Proficiency
X	Sales Representatives	Sell goods or services for wholesalers or manufacturers to businesses or groups of individuals. Work requires substantial knowledge of items sold.	10%	Below Average
X	Bookkeeper	Compute, classify, and record numerical data to keep financial records complete. Perform any combination of routine calculating, posting, and verifying duties to obtain primary financial data for use in maintaining accounting records. May also check the accuracy of figures, calculations, and postings pertaining to business transactions recorded by other workers.	10%	Below Average
X	Purchasing Clerk	Compile information and records to draw up purchase orders for procurement of materials and services.	5%	Average
X	Business Office Manager	Plan, direct, or coordinate one or more administrative services of an organization, such as records and information management, mail distribution, facilities planning and maintenance, custodial operations, and other office support services.	15%	Average
Please list any specialized tasks which fall outside the common tasks that you've already selected from. You may add as many specialized tasks as you need to adequately account for all the other tasks you perform for your business regularly throughout the year and then rate your skill level for each task added. (Example: Veterinarian; Hair Stylist; Pastry Chef; Etc...)				
Title	Description	Time %	Proficiency	
Concrete Finisher	Smooth and finish surfaces of poured concrete, such as floors, walks, sidewalks, roads, or curbs using a variety of hand and power tools. Align forms for sidewalks, curbs, or gutters; patch voids; and use saws to cut expansion joints.	30%	Above Average	
Maintenance Mechanic	Perform work involving the skills of two or more maintenance or craft occupations to keep machines, mechanical equipment, or the structure of an establishment in repair. Duties may involve pipe fitting; boiler making; insulating; welding; machining; carpentry; repairing electrical or mechanical equipment; installing, aligning, and balancing new equipment; and repairing buildings, floors, or stairs.	30%	Above Average	
		100%	TOTAL	





Report for Scott Stone of Stone Concrete, Inc.

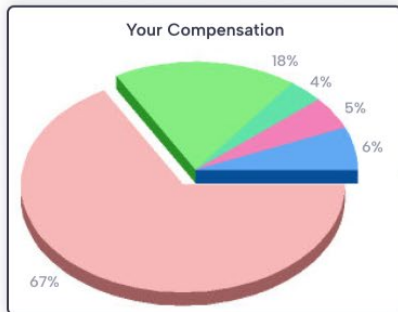
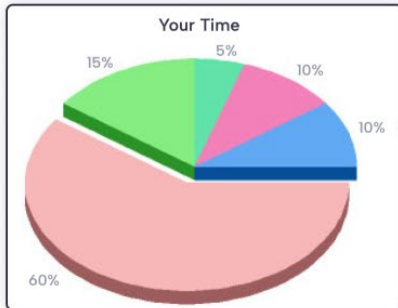
Your estimated annual Reasonable Compensation: \$68,788

Thank you for entrusting Sam Miller of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your S Corporation based on your responsibilities and the duties that you perform annually. Reasonable Compensation is defined by the IRS as "The value that would ordinarily be paid for like services by like enterprises under like circumstances".

The calculated salary of **\$68,788** determined to be reasonable compensation based on the types of work performed, the skill level of the owner, the location of the business, the industry, the number of hours the work is performed annually. You told us that you work 2080 hours per year. An analysis indicates the annual salary of \$68,788 would be a reasonable cost to hire someone to perform the duties and responsibilities that you currently perform.

Cook County, IL

Potomac Tax and Valuation, PC recommends completing a reasonable compensation report annually.



- My Business
- Management - Supervision
- Purchasing - Inventory - Shipping - Receiving
- Accounting - Finance - Bookkeeping
- Advertising - Sales - Marketing

Compensation Details

Detailed breakdown of the compensation tied to each task that the owner performs.

Reasonable Compensation Figure

Details the salary range for the owner's industry and provides a reasonable compensation figure.

Task Category

Categories of tasks completed by the owner.

Standard Tasks & Proficiency

Tasks commonly associated with running a small business and the Owner's proficiency level for this specific task.

My Business Tasks

Specialized tasks the owner performs for their business that fall outside of standard business tasks.

Your Compensation

How the compensation number is affected by each task the owner performs.



Report for Scott Stone of Stone Concrete, Inc.

Advertising - Sales - Marketing	10% of your time	208 hours per year	6.4% of your comp.
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Task	Proficiency	Category	Overall	Hours	Wage	Annual
Sales Representatives	Below Avg.	100%	10%	208.0	\$21.18	\$4,405

Accounting - Finance - Bookkeeping	10% of your time	208 hours per year	4.88% of your comp.
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Task	Proficiency	Category	Overall	Hours	Wage	Annual
Bookkeeper	Below Avg.	100%	10%	208.0	\$16.16	\$3,361

Purchasing - Inventory - Shipping - Receiving	5% of your time	104 hours per year	3.57% of your comp.
---	-----------------	--------------------	---------------------

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Purchasing Clerk	Average	100%	5%	104.0	\$23.61	\$2,455

Management - Supervision	15% of your time	312 hours per year	18.28% of your comp.
--------------------------	------------------	--------------------	----------------------

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Business Office Manager	Average	100%	15%	312	\$40.33	\$12,583

My Business	60% of your time	1,248 hours per year	66.85% of your comp.
-------------	------------------	----------------------	----------------------

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Concrete Finisher	Above Avg.	50%	30%	624.0	\$45.21	\$28,211
Maintenance Mechanic	Above Avg.	50%	30%	624.0	\$28.48	\$17,772



Percentage of Time & Annual Hours

Annual percentage of owner's time spent on that task and hours per year the owner spends on this task.

Hourly Wage & Annual Compensation

Hourly wage for this task based on location and proficiency and hourly wage x annual hours worked for that task.

How – Market Approach

AKA Industry Comparison Approach



How – Market Approach

- Size
- Industry
- Management
- Comparability Data
- Medium Business




Scott Stone at 45

In order to help us build your Reasonable Compensation profile, tell us a little more about yourself and your business:

Industry	Specialty trade contractors
Occupation	CEO
State	Illinois
Metro area	Chicago
Number of employees	35
Adjusted Gross Profit	3.5 Million
Business performance versus peers	Above average
Owner experience versus peers	High
Hours worked per week on average	55






Page 1 of 4

Report for Scott Stone of Stone Concrete, Inc.

Your estimated annual Reasonable Compensation: \$275,211

Thank you for entrusting Paul Hamann of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your company based on the duties and responsibilities that you perform annually. The valuation of most businesses requires the owner(s) and key managers to have their compensation *Normalized*. Reasonable Compensation is defined as "The hypothetical replacement cost of an owner or key manager of a business."

Your suggested salary range: \$222,023 to \$321,060 with a suggested salary of \$275,211 was determined to be Reasonable Compensation based on your role in the company, industry, size of the business, time devoted to the business, your experience and location. Any wage selected within the suggested range or expanded geographical area(s) is acceptable and within a 90% confidence interval.

Salary Range

	Low	High	Suggested
Chicago-Naperville-Elgin, IL-IN-WI	246,996	321,060	262,003
Illinois	235,142	305,652	262,003
National	222,023	288,599	247,385

Reasonable Compensation Calculation
Details the salary range for the owner's industry and location and provides a suggested reasonable compensation figure.

Reasonable Compensation Figure
Quickly view the calculated reasonable compensation figure with supporting details.


Page 2 of 4

Report for Scott Stone of Stone Concrete, Inc.

Calculated for
Scott Stone

Company
Stone Concrete, Inc.

Interview completed
2022-04-11 22:49:14

Report calendar year
2022

NAICS industry
238000 - Specialty Trade Contractors

MSA Location
Chicago - Naperville - Elgin, IL- IN - WI

State
Illinois

Occupation
Chief Executives

Number of Employees (FTE)
25-75

Adjusted Gross Profit
1m-5m

Business Performance vs. Peers
Above Average

Owner Experience/Proficiency Level
High

Time dedicated to the business
Workaholic (65+ hrs/week)

Business Summary
Details the inputs provided to reach the suggested Reasonable Compensation figure.

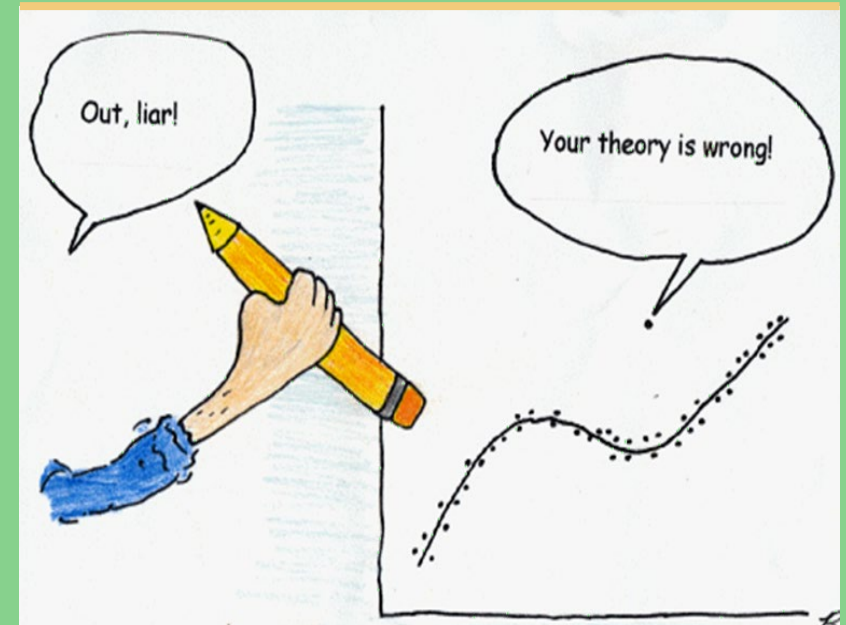
How – Income Approach

AKA Independent Investors Test



How – Income Approach

- No Comparable Wage Data
- ROI v. Reasonable Compensation
- Outliers
- 2nd Opinion/Test




Scott Stone at 55

In order to help us build your Reasonable Compensation profile, tell us a little more about yourself and your business:

Estimated FMV beginning of the year	6,000,000
Estimated increase in FMV by year end	1,750,000
Target return (independent investor rate)	20%



Scott Stone at 55


POTOMAC
 Tax & Valuation

Page 1 of 5

Report for Scott Stone of Stone Technologies, Inc.

Your estimated annual Reasonable Compensation: \$550,000

Thank you for entrusting Sam Miller of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your C Corporation based on your responsibilities and the duties that you perform annually. Reasonable Compensation is defined by the IRS as "The value that would ordinarily be paid for like services by like enterprises under like circumstances."

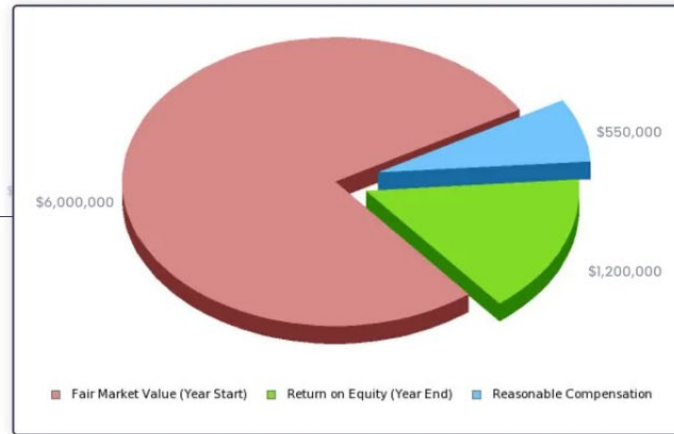
The calculated salary of \$550,000 was determined to be Reasonable Compensation based on the increase in the Fair Market Value of your company over a one year time frame and a Return on Investment of 20.00% in conjunction with your efforts.

Potomac Tax and Valuation, PC recommends completing a Reasonable Compensation report annually.

Reasonable Compensation Figure
 Quickly view the calculated reasonable compensation figure with supporting details.

Reasonable Compensation Calculation
 Based on what a hypothetical investor would be satisfied with when looking at the financial performance of the business in conjunction with the compensation level of the owner.

In this approach, if investors obtain returns above what they should reasonably expect, an employee's salary is presumptively reasonable. This approach can only be used when you have Fair Market Value (FMV) for each year compensation is being evaluated.



In order to help us build your Reasonable Compensation profile, tell us a little more about yourself and your business:

Estimated FMV beginning of the year	6,000,000
Estimated increase in FMV by year end	1,750,000
Target return (independent investor rate)	20%

Polling Question

Would you be interested in a personalized, 30-minute demo of RCReports?

A. Yes, that'd be great!

B. No, thanks

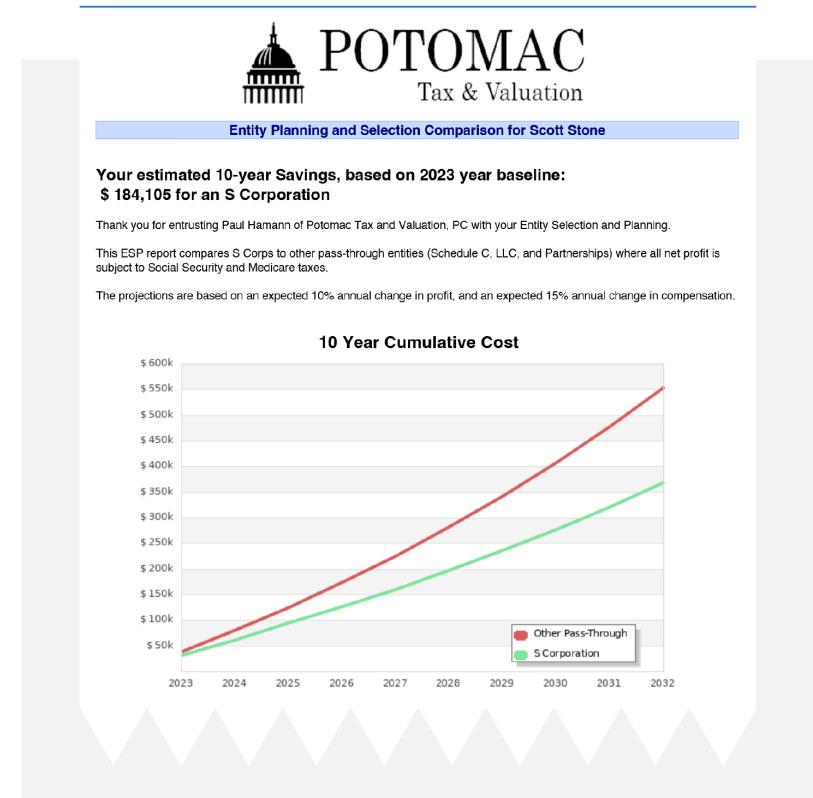


"I hear you're the expert on loyalty."

Advice from RCReports

- Send Issue Letter
- Stress Test
- Entity Selection/Planning

“ The first with a fact-based figure wins



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Who We Are



Paul S. Hamann

Founder

paul@RCReports.com



Eric Green, Esq.

Green & Sklarz LLC

egreen@gs-lawfirm.com

RCR

Ready to use RCReports?

\$300 OFF Premium

Code: **LASTCHANCE24**

\$500 OFF Professional

Code: **LASTCALL24**

accountingTODAY accountingTODAY
TOP TOP
NEW PRODUCTS 2016 APPS FOR ACCOUNTANTS 2024



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