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What's the "Right Amount" of Compensation for an S Corporation Shareholder/Employee?

The S corporation has been used by small business owners to avoid payroll taxes, and the IRS knows it. In fact, there is a compliance initiative underway to find as many of those abusive situations as possible and assess appropriate payroll taxes. Here is a case that describes how a CPA got into trouble with his own S corporation, how he got out, and how you can avoid the mistakes he made.

An unpublished opinion of the U.S. Tax Court provides an important insight into the issue of "reasonable compensation" when considering a defensible minimum amount for an S corporation shareholder/employee. Many tax advisors agree that you can use this opinion as reliable guidance (even though it is not binding precedent) when planning such compensation. Here's a brief summary of the relevant facts and the Court's decision.

Wiley Barron, a CPA, formed an S corporation to practice public accounting in Arkansas. The S corporation made substantial distributions of profits to him, but treated only $2,000 -- in one quarter during a three-year period -- as compensation subject to employment taxes. The S corporation was examined for payroll tax compliance by an IRS "officer/examiner" specially trained to deal with worker classification and payroll tax issues. She assessed payroll tax deficiencies to account for reasonable compensation and Wiley appealed to the U.S. Tax Court, where he represented himself under the Court's small case procedures.

In its opinion, the Tax Court said that Wiley "was the individual who was solely responsible for making management decisions and for controlling every facet of (his) business." He was the only CPA employed by the corporation, he worked at it nearly full time, but he didn't pay himself a salary. Since the general rule is that a corporate officer is an employee [See Internal Revenue Code Section 3121(d)], it's fairly obvious that Mr. Barron was using his S corporation to avoid employment tax on his compensation: in this case, all or part of the S corporation's earnings which were distributed to him.

Mr. Barron is certainly not the first small business owner to use an S corporation to avoid payroll taxes on his income, and the IRS has aggressively pursued many of them. Until now, the position of the IRS had been -- and the Courts had generally agreed -- that the entire amount of S corporation distributions should be reclassified as compensation.

But the outcome of this particular case is unique and offers guidance for establishing reasonable compensation at less than total distributions from the S corporation. The Tax Court agreed with the revenue officer/examiner's proposed adjustments, which were based on information from Robert Half Associates regarding what "reasonable compensation" for a CPA of Mr. Barron's training and experience would be in the area of Arkansas where he practiced. That "reasonable compensation" was in the range of $45,000 to $49,000 for the years in dispute. Even though the S corporation had distributed from $56,000 to $83,000 in those years, only the amount of "reasonable compensation" based on the reliable comparable data was recharacterized as compensation and subjected to Social Security and Medicare taxes.

You do not have to live with uncertainty on this issue. We can help you determine reasonable compensation levels for S corporation shareholder/employees. We have full access to reliable comparable data and a complete library of federal tax reference material. Please call us to schedule an appointment.