Tax Tips

**Compensation Should Be Neither Too High Nor Too Low**

Business owners can avoid tax problems by paying attention to the amount of money they receive for working for the company. That’s true whether you run your business as a C corporation or an S corporation.

**C corporation challenges**

If you run your company as a regular C corporation, you’ll find yourself exposed to two layers of tax. First, money you receive from the company will be subject to personal income tax. Second, corporate income tax will be due on the net income of the business. Some business owners attempt to get around this problem by “zeroing out” corporate income. If the company makes $100,000, for example, it pays a $100,000 bonus to its sole owner. Now the company has zero taxable income and owes no corporate income tax.

That might be a viable strategy, but it might not. The IRS will look at the total compensation package of a C corporation owner (salary, bonus, benefits) to see it’s reasonable. Amounts deemed unreasonable will be re-cast as dividends, which are taxable to the individual but not deductible by the company.

***Example #1:*** Nancy Green is the sole owner of a C corporation. She zeroes out corporate income by paying herself a $100,000 bonus, bringing her total compensation for the year to $500,000. The IRS, examining the company’s tax return, asserts that reasonable compensation for Nancy would be $400,000, judging by her experience, corporate performance, and industry norms.

Thus, Nancy’s $100,000 bonus is characterized as a dividend, which is not deductible from her company’s income. The corporation winds up owing tax on $100,000 in profits, while Nancy owes income tax on the $100,000 bonus as well as her salary. In effect, that $100,000 bonus is taxed twice, on a personal and on a corporate tax return.

**S corporation snag**

One way to avoid this type of double taxation is to make an S corporation election for your company, assuming it will qualify. (A number of tests must be passed, including having no more than 100 shareholders, all of whom are individuals, their estates, other S corporations, or certain types of trusts.) All S corporation income flows through to the owners, so there is no corporate income tax to pay. Therefore, unreasonably *high* compensation won’t be an issue.

Here, a problem may result if the IRS finds an S corporation owner is taking unreasonably *low* compensation. Only earned income is subject to Social Security and Medicare tax, while all earnings are subject to a 2.9% Medicare tax. Corporate profits are subject to neither payroll tax.

***Example #2:*** Andy Parker owns 100% of an S corporation. He pays himself a $40,000 salary this year and takes $100,000 from his company as profits. The IRS might say that Andy has $140,000 in compensation, driving up the Social Security and Medicare tax he must pay. Indeed, the IRS increasingly has been raising the issue of inadequate compensation with S corporations and their shareholders.

**Up to the minutes**

These tax traps can be averted with astute planning. Whether your business is a C or an S corporation, it is supposed to have regular meetings of shareholders and directors. You should keep minutes of what’s discussed at those meetings, and those minutes can explain your compensation arrangement.

If you have any questions regarding the above discussed topic or any other tax matter, please feel free to give me a call at (562) 698-9891.

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