REASONABLE COMPENSATION

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The C-Corporation -- The two primary ways of taking money out of a C-corporation is as compensation for work as an employee or as a dividend. Each has different tax consequences. Salaries and bonuses are deductible by the corporation and taxable to the recipient employee, whereas dividends, are not tax-deductible by the corporation and are taxable to the stockholder recipient. Thus, in the case of a C-corporation, the dividends are taxed twice.

If you think the C-corporation shareholder can avoid double taxable by only taking compensation and never paying dividends – think again! To counter that strategy, tax law includes a provision that says compensation can be deducted only to the extent that it is reasonable. This is most frequently encountered where the employee is a shareholder or is related to a shareholder.

The S-Corporation -- An S-corporation is a “pass through” entity. In the case of an S-corporation, the shareholder’s portion of net income from the corporation is passed through to his individual tax return, even if not actually distributed. While the S-corporation shareholder’s salary is subject to 15.3% in FICA taxes, the other pass-through income (after salary and other expenses) is not subject to those FICA taxes. That net income passing through is only subject to income tax at that individual’s tax rate.

Generally, the S-corporation shareholder wants his salary to be low to avoid FICA taxes and have a higher net income that is only subject to income taxes. However, if you think the S-corporation shareholder can take no salary and only be responsible for income tax on the net income passed through, think again! To counter that strategy, if the corporation is profitable, the shareholder-employee is required to take a reasonable salary.

What is Reasonable Compensation? – There is no magic formula for determining reasonable compensation. It is generally based on fact and circumstances and what is comparable for other companies in the same business. Factors that are considered when making that determination include:

- Salaries of non-shareholder employees
- Compensation agreements
- Formula to determine compensation
- Rate of pay for similar services by comparable businesses
- Time spent to perform job duties
- Employee’s duties and responsibilities
- Employee’s abilities, training, experience, accomplishments
- Income of the company, both gross and net
- Historical compensation and dividend history
- Amount of a shareholder’s capital investment
- Time and manner of paying bonuses to key people

Avoid Pitfalls -- To reduce the chances of having compensation deemed as “unreasonable” by the IRS, there are some steps you can take. For example:

- Document in the corporate minutes the reasons for the level of salary or why bonuses are being paid.

● If the current year's salary has been increased to make up for a salary that was too low in prior years, document that in the corporate minutes. Hopefully, you included notations in the prior years' minutes stating that the compensation was at a reduced rate.

● Don't pay salaries in direct proportion to the stock ownership. It looks too much like a disguised dividend.

● Keep your salary in line with others in the same industry. Document your research in case you are later called upon to prove it.

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The issue of reasonable compensation usually occurs a couple of years after the payments are made and can have effects on multiple years. Therefore, it is best to plan ahead to avoid problems later.

If we can assist you with this issue, please give us a call.