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Income from an S corporation, which flows through to its shareholders and is taxed at the individual level, is normally not subject to self-employment tax (Rev. Rul. 59-

221). Most S corporations, however, have shareholders performing substantial

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Beginning in 2013, the additional 0.9% Medicare tax imposed by Sec. 3101(b)(2) for high-wage earners (but not on employers) provides an even greater incentive for shareholders to take less salary and more cash as a distribution from the corporation.

The term “employee” includes an officer of a corporation or any individual who has the status of an employee under Sec. 3121(d). Corporate officers are clearly employees, and any payments to them for performance of services are considered wages subject to payroll taxes and federal income tax withholding.

The instructions to Form 1120S, *U.S. Income Tax Return for an S Corporation*, state, “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.” The IRS considers no or low salary to a shareholder who is also an officer an attempt to evade payroll taxes.

The penalty for failing to pay payroll taxes is 100% of the taxes owed (Sec. 6672). An S corporation tax return that reports little or no compensation to its shareholder/officer often draws the IRS's attention. The IRS can and will go after the corporation and the shareholder to collect payroll taxes on officer compensation. Taxpayers and the IRS often disagree about the correct treatment of payments to shareholder/employees because many S corporations are closely held and therefore are not dealing with shareholder/employee payments at arm's length (see *Watson*, 668 F.3d 1008 (8th Cir. 2012)). When reviewing these payments, both the IRS and the courts look at the factors discussed below.

Did the officer/shareholder provide substantial services?

Regs. Sec. 31.3121(d)-1(b) provides that an officer of a corporation who does not perform any services or performs only minor services and who neither receives nor is entitled to receive any remuneration is not considered an employee of the

corporation. Therefore, to determine if the officer is an employee under Sec. 3121, it is

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In *Veterinary Surgical Consultants, P.C.*, 117 T.C. 141 (2001), the sole shareholder reported all of his income from his S corporation, of which he was the sole employee who generated all of its income, as S corporation distributions. The Tax Court, however, agreed with the IRS that the shareholder was an employee of the corporation and that the distributions were compensation for services that should be subject to payroll taxes.

Is the compensation reasonable?

Zero pay, low pay, or too much pay that is not justified by services performed are examples of unreasonable compensation. Several factors determine reasonableness of compensation: the employee's qualifications; the nature, extent, and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid; the prevailing general economic conditions; comparison of salaries with distributions to shareholders; the prevailing rates of compensation paid in similar businesses; the taxpayer's salary policy for all employees; and, in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years (see *Mayson Mfg. Co.*, 178 F.2d 115, 119 (6th Cir. 1949)).

According to the IRS, the key to establishing reasonable compensation is determining what the shareholder/employee did for the S corporation. So the IRS looks to the source of the S corporation's gross receipts. If they came from services of nonshareholder employees, or capital and equipment, then they should not be associated with the shareholder/employee's personal services, and it is reasonable that the shareholder would receive distributions as well as compensation.

On the other hand, if most of the gross receipts and profits are associated with the shareholder's personal services, then most of the profit distribution should be allocated as compensation. In addition to the shareholder/employee's direct

generation of gross receipts, the shareholder/employee should also be compensated

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Documentation is the key for taxpayers to justify their position in case the IRS questions payments to shareholder/employees. Have well-drafted employment agreements; use a consistent approach each year to determine pay and bonuses; and establish reasonableness by evidence of the company's gross sales and profits, the experience and competence of the officer/employees, and the time devoted to the business (*Faucette Co., Inc.*, 17 T.C. 187 (1951)). By doing so, taxpayers can show that their compensation plans were adopted in good faith, and the payments are in fact reasonable.

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