

## S CORPORATIONS AND UNREASONABLE COMPENSATION

Barry H. Williams, King's College

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### ABSTRACT

The tax gap is a measure of the difference between the taxes that should have been timely collected when the tax is due and the actual amount of the tax collected. This tax gap has been estimated to have reached \$350 Billion a year and without action by the Congress this problem would impact upon the ability of the government to provide services as they do currently. In evaluating the tax gap, the underreporting of compensation to reduce the payment of Social Security and Medicare taxes must be considered. Proposals to Congress address this underreporting of compensation by extending to partners and S Corporation shareholders both the Social Security and Medicare taxes upon the earnings of the pass-through entities reported on their tax returns. This change in the tax law could impact upon some of the traditional concepts of unreasonable compensation and understated compensation as well as the traditional views for selecting the form of business entity by new and existing businesses.

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### INTRODUCTION

The recent scandals at Corporations such as Enron and WorldCom have brought to the forefront the result corporate fraud has upon the employees, investors and the public at large. At the heart of these scandals and other famous cases, such as Martha Stewart Living Omnimedia, are the personal actions which lead to increasing the personal wealth of the Corporation's shareholder-employees. While some of the cases involved creation of wealth through an increase in stock value, others have faced scrutiny for excessive and unreasonable compensation packages.

Unreasonable compensation has been addressed in I. R. C. § 162(a)(1) (CCH 2005) which states that payment for services is only deductible to the extent of a "reasonable allowance" for the services. To provide what was perceived as a partial solution to the unreasonable compensation issue, I. R. C. § 162(m) (CCH 2005) was enacted to limit executive compensation to one million dollars unless it is based upon performance as specified in the Internal Revenue Code. For publicly traded corporations the issue of reasonableness becomes one of evaluating the performance criteria underlying the compensation package and how it impacts the ethical behavior of the corporation's executives regarding the operation and accounting practices of the Corporation.

For small business owners a concern of the Internal Revenue Service is the area of compensation and its reasonableness for a C Corporation shareholder-employee along with the possible reclassification of the unreasonable salary to

dividends. One method which qualifying small business corporations have turned to as a means of eliminating this problem is to elect S Corporation status. As an S Corporation shareholder-employee, even if reclassification from salary to a dividend occurs, there is no double taxation since the S Corporation is a pass through entity which eliminates the possible double taxation of a dividend distribution.

The election of S Corporation status by a corporation brings with it the potential opposite possibility from unreasonable compensation. The electing S Corporation can eliminate the compensation of its shareholder-employees and replace the payments with nontaxable distributions, in doing so the Social Security and Medicare taxes which would normally be paid are not paid by the taxpayer to the United States Treasury. The issue from the S Corporation perspective is understated compensation.

As a means of improving tax compliance which in turn becomes increased revenues to the United States Treasury, the Joint Committee on Taxation has issued a series of proposals. One proposal of the Joint Committee on Taxation is to modify the current system of collecting Social Security and Medicare taxes from partners and S Corporation shareholders. This proposal to tax S Corporation earnings and distributions may be forthcoming from Congress. (Summary of Joint, 2005)

### UNREASONABLE COMPENSATION

I. R. C. § 162(a)(1) (CCH 2005) allows "a reasonable allowance for salaries or other

compensation for personal services actually rendered” to be deductible as a trade or business expense on the taxpayers tax return. When the taxpayer is a C Corporation, the payment of salaries to its’ shareholder-employees can become the subject of controversy with the Internal Revenue Service due the potential for characterization issues between salaries and dividends. When the salary amount of a shareholder-employee is deemed to be excessive, the unreasonable portion must be recharacterized as something other than compensation. (Sikon, 2004) The determination of reasonableness, while disputed within the Courts, can be summarized in a nine part test:

1. What are the employees’ qualifications;
2. Are dividends distributed by the Corporation and what are the amounts in comparison to the salary;
3. How does the salary compare to salaries for comparative positions in comparative businesses;
4. The nature and scope of the work;
5. The size of the business and the complexity of the business;
6. The relationship of salary paid to the income of the business;
7. The salary in relation to the salary policy of other employees;
8. The salary of the employee-shareholder in previous years; and
9. Whether a reasonable shareholder would agree to the level of compensation. (*Mayson Manufacturing Co. v. Comm.*, 1949 and *Alpha Medical, Inc. v. Comm.*, 1999)

Once the determination of the unreasonable amount is made, the payment must then be classified as a dividend or some other form of payment. When the payment is reclassified as a dividend, it loses its status as a deductible expense and becomes a nondeductible expenditure of the Corporation to the shareholder. (I. R. C. §301 CCH 2005) The payment does not become nontaxable to the shareholder upon the reclassification but is recharacterized from compensation received to dividends received. To the extent that the dividend is paid from current or accumulated earnings and profits of the corporation, the shareholder is in receipt of a taxable dividend distribution from the corporation which is taxed as ordinary income or at a preferential rate for qualified dividend distributions. (I. R. C. §§ 301(c)(1), 316 and 1(h)(11) CCH 2005) The corporation and the shareholder are both taxed on the income and double taxation of the distribution occurs.

The tax ramifications for a corporation and shareholder-employee who are both in the top income tax brackets are shown in Table I. (I. R. C. §§ 1, 11, 3101 and 3111 CCH 2005) Classifying a distribution as salary expense to the corporation and salary income to the shareholder-employee produces a net increase in cash to the shareholder-employee of \$1,697. This savings results from a tax savings to the corporation of \$4,292 with a corresponding tax increase to the shareholder-employee of \$2,595, the difference of which is the net increase in cash to the shareholder-employee of \$1,697.

Table I		
	Corporation	Shareholder
<u>Dividend Distribution Treatment</u>		
Tax Rate	35%	35%
Dividend Distribution	\$10,000	\$10,000
Pretax Earnings Required To Net Distribution Amount	\$15,385	
Federal Income Tax Liability	\$5,385	\$3,500
Net Cash Available To Shareholder		\$6,500
<u>Salary Treatment</u>		
Tax Rate	0%	35%
Salary Amount	\$14,292	\$14,292
Federal Income Tax Liability	\$ -0-	\$5,002
Social Security And Medicare Tax	\$1,093	\$1,093
Total Tax Liability		\$6,095
Net Cash Available To Shareholder		\$8,197
Increase In Net Cash To Shareholder From Salary Treatment		\$1,697
Net Tax Savings	\$4,292	(\$2,595)

Subsequent to the enactment of the Jobs and Growth Tax Reconciliation Act of 2003 (P.L. 108-27), the tax rate on a qualifying dividend distribution was reduced to 15% for most taxpayers during the calendar years 2003 to 2008. Individuals in the 10% or 15% tax bracket are subject to an even more

reduced rate of 5% on dividends paid for 2003 to 2007 with an exemption for these taxpayers for the year 2008. (I. R. C. § 1 CCH 2005) The change in the federal income tax rate to the shareholder can make a difference in the amount of money available to the shareholder-employee after all taxes are paid. Utilizing the same example as in Table I, the changes in the net cash are shown in Table II when the federal income tax rate on the dividend distribution is 15%.

<b>Table II</b>		
	<b>Corporation</b>	<b>Shareholder</b>
<i>Dividend Distribution Treatment</i>		
Tax Rate	35%	15%
Dividend Distribution	\$10,000	\$10,000
Pretax Earnings Required To Net Distribution Amount	\$15,385	
Federal Income Tax Liability	\$5,385	\$1,500
Net Cash Available To Shareholder		\$8,500
<i>Salary Treatment</i>		
Tax Rate	0%	35%
Salary Amount	\$14,292	\$14,292
Federal Income Tax Liability	\$ -0-	\$5,002
Social Security And Medicare Tax	\$1,093	\$1,093
Total Tax Liability		\$6,095
Net Cash Available To Shareholder		\$8,197
(Decrease) In Net Cash To Shareholder From Salary Treatment		(\$303)
Net Tax Savings	\$4,292	(\$4,595)

To take advantage of these rates the dividends must be received from either a domestic corporation or qualified foreign corporation. Two further requirements for the individual shareholder-taxpayer are the taxpayer cannot hold both a long and short position in the stock simultaneously and the stock must be held for more than 60 days during the 120 days beginning 60 days before the ex-dividend date. A further deterrent placed upon the dividends is they are not considered investment income for the

purpose of the investment tax credit unless the taxpayer elects to treat the dividend income as ordinary income, forgoing the opportunity of the reduced rates. (I. R. C. § 1(h)(11) CCH 2005)

The ramification of these changes in the Internal Revenue Code for a shareholder-employee is the possibility of using underreported wages reporting those distributions as underreported earnings. Since the distribution illustrated in Table II treated as a dividend increases the net cash available by \$303 over the same treatment as salary, a possible reversal of tax strategies could occur. Salary could be intentionally reduced in order to increase the amount of cash available to the shareholder and the corporation. Under this circumstance the C Corporation shareholder-employee could find themselves in the same planning mode as an S Corporation shareholder-employee.

### **S CORPORATION DISTRIBUTIONS**

Since 1997, S Corporations have been the most prevalent tax return filed by corporations with the average annual growth in S Corporation returns increasing annually at an approximate rate of 9% since the enactment of favorable tax legislation in 1986. (Luttrell, 2005) In terms of the number of Form 1120S's, the actual number filed for 2002 were 3,191,108 with the projection for 4,239,700 to be filed in 2010. (Manzi, 2004) A major benefit of S Corporations, which partially accounts for the number of corporations electing S Corporation status, comes from the elimination in many cases of the double taxation of a C Corporation shareholder on dividend distributions. (Luttrell, 2005)

In order to achieve S Corporation status, the corporation must meet the definition of a small business corporation and file the appropriate election. (I. R. C. §§ 1361, 1362 and 1363, CCH 2005) Once the election is made the S Corporation shareholders report the items of income, loss, deductions and credits on their tax returns with the determination of the character of the items determined at the S Corporation level. (I. R. C. § 1366 CCH 2005) The determination of the tax treatment of distributions is based upon these items, the presence of accumulated earnings and profits, the accumulated adjustments account and the tax basis of the shareholder. (I. R. C. §§ 1366, 1367 and 1368 CCH 2005)

The taxation of distributions from an S Corporation comes within two rules based upon the existence or non-existence of C Corporation earnings and profits. When the S Corporation has no earnings

and profits, which generally occurs when the S Corporation election was made at the date of incorporation, the distribution is a tax free recovery of capital to the extent of the adjusted basis in the shareholders stock. (I. R. C. § 1368(b)(1) CCH 2005) The amount of any distribution in excess of the adjusted basis of the shareholders stock will be treated as a sale or exchange of stock. (I. R. C. § 1368(b)(2) CCH 2005)

When an S Corporation has C Corporation earnings and profits, the accumulated adjustments account is used to trace the undistributed earnings of the S Corporation, distributions to the shareholders from a positive balance in the accumulated adjustments account are exempt from taxation. (I. R. C. §§ 301, 316 and 1368(c)(1) CCH 2005) To the extent that distributions exceed the accumulated adjustments account, the distribution is taxed as a C Corporation dividend to the extent of the earnings and profits. (I. R. C. § 1368(c) CCH 2005) This rule is intended to prevent a corporation from electing S Corporation status and distributing pre-S Corporation earnings and profits as non-taxable distributions.

To the extent that the rules of Sub Chapter S of the Internal Revenue Code of 1986 (CCH 2005) does not conflict with those of C Corporations, the C Corporation rules apply. The impact of this upon the shareholder-employee is that the amount of their salary is subject to the same scrutiny for reasonableness and for the application of payroll taxes as a C Corporation would have. Shareholder-employees have taken advantage of the S Corporation election to reduce the salaries their corporations pay them and replace these salaries with distributions not subject to Social Security and Medicare taxes. (O'Brien, 2005) Utilizing the same amounts from Tables I and II, the comparison of salary to non-taxable distributions are displayed in Table III.

The significance of the increase in net cash to the shareholder-employee is that on a \$15,385 distribution classification, an increase of \$1,803 occurs. When considering that there were 3,191,108 S Corporation tax returns filed for 2002 (Manzi 2004), the potential for an understatement of tax liability if this amount of reduced tax liability were applied to all filed tax returns, both income tax and employment taxes, would be \$5.75 Billion. In his opening statement before testifying to Congress on April 14, 2005, U. S. Senator Max Baucus reported that a tax gap, the difference between reported taxes and actual tax liability, amounted to as much as \$353 billion with underreporting of employment taxes estimated to be \$71 billion. (Statement of U., 2005)

Considering a small abuse on all the returns filed for 2002 would only amount to 8% of the estimated payroll tax underreporting the underreporting of salary could be far more extreme.

Table III		
	<u>Corporation</u>	<u>Shareholder</u>
<u>Dividend Distribution Treatment</u>		
Tax Rate	0%	35%
Dividend Distribution	\$15,385	\$15,385
Pretax Earnings Required To Net Distribution Amount	\$15,385	
Federal Income Tax Liability	\$-0-	\$5,385
Net Cash Available To Shareholder		\$10,000
<u>Salary Treatment</u>		
Tax Rate	0%	35%
Salary Amount	\$14,292	\$14,292
Federal Income Tax Liability	\$ -0-	\$5,002
Social Security And Medicare Tax	\$1,093	\$1,093
Total Tax Liability	\$1,093	\$6,095
Net Cash Available To Shareholder		\$8,197
Increase In Net Cash To Shareholder From Dividend Distribution Treatment		\$1,803
Net Tax Savings	\$1,093	\$710

In making the determination of whether or not the salary paid to the shareholder-employee is reasonable, the Internal Revenue Service and the various Courts have developed a set of rules. The four rules developed are:

1. Compare the salary of the shareholder-employee paid by the corporation to what the same individual would have made working for an unrelated corporation;
2. Compare the percentage relationship of the salary to the S Corporation's gross income and then compare this to other corporations;
3. Look to and compare the compensation paid to the same shareholder-employee in prior years; and
4. What would an independent investor in the S Corporation consider the compensation to be, reasonable or unreasonable. (O'Brien, 2005)

The difficulty in applying the four part test to determine the accuracy of the salary amounts reported is compounded by the ability to assess compliance with the rule due to the decline in the number of examinations of S Corporations by the Internal Revenue Service. For the year 2003, 6,402 Form 1120S's were examined representing .19% of the Form 1120S's filed for the tax year. (Table 10 – Examination, 2004) Five years previous in 1999, 15,200 Form 1120S's were examined representing .55% of the Form 1120S's filed. (Table 10 – Examination, 2000) While the amount of examinations for 1999 was not large in proportion to the returns filed, over the four year period the number of returns examined was reduced by 8,798 which from the percentage standpoint represented a 65% decrease from the .55% examined.

### COMPLIANCE PROPOSAL

On April 14, 2005 the U. S. Senate Finance Committee began hearings on the tax gap and how to improve compliance amongst taxpayers as a means of alleviating the tax gap. In his opening statement, U. S. Senator Charles E. Grassley, Committee Chair, began by saying "Unfortunately, while the strong majority of Americans seek to honestly pay the amount of tax they owe and not a penny more, there are many who are playing fast and loose." (Opening Statement of, 2005) The task at hand is to utilize multiple strategies to improve upon the collection of unreported tax liabilities and to create laws which will move this task forward. The new laws can be aimed at compliance or enforcement but with either approach the enforcement limitations of the Internal Revenue Service must be understood. Past declines in the Internal Revenue Service enforcement has been caused by an erosion in enforcement occupations and

examinations by the Internal Revenue Service risk a further decline in taxpayer compliance. (Government Accounting Office, 2005)

In evaluating what strategies and changes to employ, various officials provided testimony and recommendations to the Finance Committee. Among those testifying was George K. Yin, Chief of Staff of the Joint Committee on Taxation, who outlined five general principles to follow in crafting a solution to the tax gap through legislative means.

1. Simplify the tax code;
2. Rely on objective, third party verification;
3. Avoid having tax consequences depend upon difficult factual determinations;
4. Treat income and deductions consistently; and
5. Supplement technical rules with standards. (Testimony of Joint, 2005)

The current four rules for determining the reasonableness of a shareholder-employee's salary would fail when they are applied to these principles. The question of reasonableness is a very difficult factual examination that is not readily verifiable by third party means.

The Joint Committee on Taxation has created a report on options to improve compliance and therefore close the tax gap. Within these proposals is a modification of the amounts subject to employment or self-employment taxes for partners and S Corporation shareholders. The proposal would tax partners, including general partners, limited partners and LLC members, on their distributive share with modifications for partners who do not materially participate. The Joint Committee also recognizes that S Corporations are selected as a form of doing by those who perform services and choose to reduce their social security and medicare tax payments. The shareholder-employee pay themselves below the wage cap for social security while treating the remaining compensation as a non-taxable distribution. (Summary of Joint, 2005) Making a change to improve compliance for partners would be ineffective if the partners could elect S Corporation status thus avoiding the new rules for the collection of social security and medicare taxes.

In order to eliminate any selection of business entity due to the inconsistency in the payroll tax treatment of S Corporation shareholders and partners, a modification the amount subject to payroll taxes has been made. Under the Joint Committee

proposal, for purposes of employment taxes, and S Corporation would be treated as a partnership with the shareholders treated as partners. This approach would cause profits from the S Corporation to be subject to social security and medicare tax eliminating the tax motivated decision in electing the form of business entity. (Summary of Joint, 2005)

From a financial perspective, the S Corporation shareholders being subject to self-employment tax may change the underreporting of salary. When the S Corporation shareholder-employee was not subject to the self-employment tax on dividend distributions, Table III showed an increase in the net cash available to the shareholder-employee. The net increase of \$1,803 on \$15,385 of distribution occurred when the distribution was treated as a dividend distribution instead of salary. Under the proposed change, Table IV utilizing the same base distribution amounts as the other examples indicates an increase in the net cash available to the shareholder-employee of \$551 this time from treating the amount as salary. On a base outlay of \$15,385, a change from taking a dividend distribution from the S Corporation to taking a salary would increase the net cash available to the shareholder-employee by \$2,354 or 15% of the base amount.

A further possibility which needs to be explored is having the selection of a business entity not be an S Corporation. The net cash available to a C Corporation shareholder-employee who takes the \$15,385 in distributions as a taxable dividend are \$8,500. (Table II) This net cash to the shareholder-employee exceeds either of the net cash available amounts under the new proposal as outlined in Table IV. Should this new proposal become legislation, the upward trend in S Corporation elections may level off or even decline since C Corporation may obtain greater financial benefits.

Table IV		
	Corporation	Shareholder
<u>Dividend Distribution Treatment</u>		
Tax Rate	0%	35%
Dividend Distribution	\$15,385	\$15,385
Pretax Earnings Required To Net Distribution Amount	\$15,385	
Federal Income Tax Liability	\$-0-	\$5,385
Social Security and Medicare Tax	\$-0-	\$2,354
Total Tax Liability	\$-0-	\$7,739
Net Cash Available To Shareholder		\$7,646
<u>Salary Treatment</u>		
Tax Rate	0%	35%
Salary Amount	\$14,292	\$14,292
Federal Income Tax Liability	\$-0-	\$5,002
Social Security And Medicare Tax	\$1,093	\$1,093
Total Tax Liability	\$1,093	\$6,095
Net Cash Available To Shareholder		\$8,197
Increase In Net Cash To Shareholder From Salary Treatment		\$551
Net Tax Savings	(\$1,093)	\$1,644

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**Barry H. Williams** is the Chair of the Department of Accounting and Finance at King's College in Wilkes-Barre, PA. He holds a Bachelor of Science in Accounting and a Master of Business Administration from Wilkes University, a Masters in Taxation from Villanova University and a Juris Doctorate from Widener University. He is a licensed Certified Public Accountant in Pennsylvania and Florida and is a member of the Bar of the Commonwealth of Pennsylvania.

