

Adequate Compensation

In tuning owner income there are different options available depending on the business entity. Historically, C corporation owner-officers have been known to fine-tune their income by paying themselves bonuses to utilize the C corporation surtax exemption—a low tax rate on the first \$50,000 of taxable income. C corporations pay a tax on all earnings. While salaries and expense reimbursements paid to the owners are deductible to the corporation, a dividend is not. Thus, if a shareholder of a C corporation pays him or herself a dividend, it results in double taxation. The C Corporation pays the taxes on those profits and the shareholder pays taxes on this investment income. There are numerous Treasury Department cases prosecuted against C corporation owners whose salary and bonuses vary year to year. When in an audit IRS finds that the salary fluctuates unreasonably, it re-characterizes some of the salary as “disguised dividends”. As a result, the C Corp incurs a greater tax liability for loss of the salary deduction, but the shareholder merely re-characterizes salary as dividends. As a result, the Corporation is usually assessed tax, interest and penalties to the extent of the disallowed salary deduction and the overall tax paid by the Corporation and its owner(s) is substantially higher.

Because of this double taxation issue, most small corporations elect subchapter S status. Under this election (which has specific timing requirements), the shareholder elects to have all the corporation’s income reported on his/her tax return on a K-1 schedule.

Because wages paid to an owner/officer of an S corporation are considered earned income, these wages are subject to payroll taxes, as with any employee. And, like all payroll, they are deductible by the S corporation. However, dividends paid to a subchapter S shareholder are not subject to social security and other payroll taxes.

Therefore, subchapter S corporation stockholders tend to pay themselves a moderate salary and take high dividends, unless they have a corporate retirement plan. There are serious issues that arise when an S corporation shareholder goes too far and takes no salary, taking all of the income as dividends. The issues usually involve the extent of the services provided by the stockholder and the earnings of the S corporation. IRS will usually assess payroll taxes and stiff penalties when active S corporation shareholders take no salary.

For quick questions on this subject, to suggest a new topic for an overview paper, or more information on how Polito Eppich can help you make the right choices for your circumstances, please contact Paul Polito (pmp@politoeppch.com) or Don Eppich (dpe@politoeppich.com) at 760-599-9900.