



**F**ew, if any, pressure cleaning contractors or business owners believe that they are adequately compensated for the time and effort they contribute—or have contributed—to make the operation successful. How best to compensate yourself as the owner of a pressure cleaning, equipment, or supplies business is a difficult question to answer, especially under the watchful eye of the Internal Revenue Service.

Leave money in the business to avoid tax and the IRS often sees—and penalizes—“accumulated profits.” Too much compensation for a business owner/shareholder may mean that dividends were ignored resulting in a distorted tax bill. Recently, the IRS has been directing its focus to the compensation of owner-employees of pressure cleaning businesses operating as S corporations.

#### **What Is an S Corporation?**

An S corporation is an incorporated business with a limited number of shareholders (75 or fewer) that chooses or elects not to be taxed as a regular or ‘C’ corporation and meets a number of other requirements imposed by our lawmakers. Share-

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business. Double taxation means that profits are taxed, not only at the corporate level, but again at the shareholder’s level when those same profits are passed along to his or her personal income tax return. Dividends distributed to shareholders cannot be deducted by the incorporated pressure cleaning business.

#### **Getting It Out**

The tax law labels a distributive share (whether or not actually distributed) of income or loss from any trade or business carried on by a partnership as net earnings from self-employment (NEFSE). Whether this general rule applies to limited liability companies (LLCs) remains unclear; although, in theory, the distributive share of an LLC member classified as a general partner is NEFSE and that of an LLC member classified as a limited partner is not.

An S corporation shareholder, on the other hand, can be an employee of the S corporation. Any wages paid to a shareholder-employee by the S corporation are subject to payroll taxes. Similar to self-employment tax, payroll, or Federal Income Contributions Act (FICA) taxes are imposed on employees at the rate of 6.2 percent of the first

the entire amount of self-employment income for hospital insurance. An individual is allowed a deduction equal to 7.65 percent of trade or business income in calculating NEFSE.

Those pressure cleaning businesses operating as S corporations that pay shareholder-employees no salary obviously achieve significant employment tax savings, especially when compared to a sole proprietorship or partnership. Thus, it should come as no surprise that many S corporations have attempted to eliminate or minimize employment tax by making tax-free distributions to shareholder-employees, all the while paying them little or no salary even if the shareholder performs services for the business.

#### **Those Pass-Through Entities**

Partners and shareholders of S corporations are subject to tax on income (other than the entity’s dividends and capital gain) at the rates applicable to ordinary income. Even after their reduction under the new law, however, these rates can range as high as 35 percent.

Before 2003, the net income from a regular corporation’s business, paid out to shareholders as dividends, was

# tax audit target: owner compensation

by Mark E. Battersby

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In other words, an S corporation is a pass-through type of business entity, much like a partnership, that avoids corporate double taxation while providing limited liability for the shareholders in the pressure cleaning

\$97,500 of wages and a rate of 1.45 percent on the entire amount of wages. FICA is also imposed on the employer.

Self-employment (SE) tax is applied to an individual’s net earnings from NEFSE (net earnings from self-employment). The tax is applied at two levels: A rate of 12.4 percent is imposed on the first \$97,500 NEFSE for old age, survivors and disability insurance, and a rate of 2.9 percent is imposed on

taxable as the recipient’s ordinary income. By comparison, under the current tax law, shareholders of regular corporations pay tax on their dividends at 15 percent (or five percent for low-income taxpayers).

#### **An Employee: To Be or Not To Be**

Our tax rules impose FICA (Social Security) and FUTA (unemployment) taxes on employers for wages paid to their employees. Under those rules, an

employee is defined, in part, as any officer of a corporation. There is, of course, an exception to that label of “employee” for any officer who does not perform services (or performs only minimal services) and who neither receives nor is entitled to receive remuneration.

For Federal employment tax purposes, the term “wages” is defined as “all remuneration for employment.” The form of payment is immaterial, the

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only relevant factor being whether the payments were actually received as compensation for employment.

Consequently, an officer who performs substantial services for a corporation and who receives remuneration in any form for those services is considered to be an employee whose wages are subject to Federal unemployment taxes.

It should be obvious that employment tax cannot be avoided by paying no salary and instead withdrawing salary from an S corporation in the form of tax-free distributions. The rules, however, require only a “reasonable” salary.

An employer cannot avoid Federal employment taxes by characterizing compensation paid to its sole director and shareholder as distributions of the corporation’s net income, rather than as wages. Regardless of how an employer chooses to characterize payments made to its employees, the true analysis, according to the courts, has been whether the payments represent remuneration for services rendered.

### **Avoiding Mislabeling**

The first rule of thumb is that S corporations should avoid paying no officer compensation in years in which the pressure cleaning operation shows a profit. Those contractors operating as S corporations and S corporation shareholder-employees who get too greedy and attempt to eliminate all employment taxes by paying themselves no salary in the same year a distribution is made are asking for an IRS challenge.

Many tax professionals advise clients to distribute S corporation earnings using a combination of salary and distributions. A 60/40 or 50/50 salary to distribution ratio is often suggested. A pressure cleaning business operating as an S corporation might, for instance, classify payments to shareholder-officers as 60-percent salary and 40-percent distribution.

Since the issue is whether the salary is reasonable for the services performed by the shareholder-employee, a fixed ratio should not be used in every situation. Remember, however, IRS auditors are fully aware of the reasonable compensation issue and equipped with information on what is considered reasonable salary for particular industries and geographical areas. Naturally, information on average salary is only the starting point since S corporations can argue that the facts of their particular situation result in a less than average salary being reasonable.

Also, keep in mind that distributions are not the only item that the IRS can re-classify as wages subject to employment tax. The IRS can re-characterize nondividend distributions such as loans from an S corporation to a shareholder-employee as well as a corporation’s payment of a shareholder’s personal expenses.

### **A Safe Harbor**

Despite the IRS’s increased attention to unreasonably low compensation of S corporation shareholder-employees, the courts have, in the past,

allowed relief from employment tax liability—if two conditions are satisfied. Specifically, if:

“(A) for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period...,” and

“(B) in the case of periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such period are filed on a basis consistent with the taxpayer’s treatment of such individuals as not being an employee.”

Then, according to the courts, “for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee.”

### **Planning Distributions**

The tax laws permit the IRS to re-characterize the entire amount of an S corporation distribution as wages subject to employment tax where no salary is paid to the sole shareholder of a business. This means getting money from a closely-held pressure cleaning business has always been possible. Reducing the tax bite that normally accompanies the withdrawal is becoming increasingly more difficult under our tough tax rules.

The IRS has reportedly increased scrutiny in this area. They will reclassify S corporation distributions as salary subject to employment tax at the drop of a hat. The trigger is those situations where the S corporation pays the shareholder receiving the distribution no or an “unreasonably low” salary. But, just what is “unreasonably low?”

By employing salary and distribution ratios and other tax strategies—and with the assistance of a qualified tax advisor—it is both possible and affordable to get money out of any closely-held pressure cleaning business while avoiding a challenge by the IRS for “unreasonably low compensation.” *cr*