Pitfalls of Solo S Corporations: Are You Paying Yourself Enough, If at All?

Many small business owners opt for an S corporation over other entity types. It's estimated that about 5 million American businesses operate as S corps, almost three times as many C corporations. One of the chief reasons for this entity choice is that with very few exceptions, namely New York City residents, S status confers many of the same benefits as a corporation but without the "double taxation" aspect since it is what's known as a pass-through entity. Relevant income, deductions, and credits pass through to the owners on their individual tax returns, and there's no self-employment tax on the profits.

However, small business owners need to carefully consider both the risks and benefits of choosing an S corporation over a single-member LLC taxed as a sole proprietorship. One of those risks is the reasonable compensation rule.

The reason why there's no self-employment tax on S corporation profits is because officers of a corporation, even if it's just you, are considered employees and need to be paid a reasonable salary. A recent Tax Court case, Lateesa Ward et al. v. Commissioner, (*T.C. Memo 2021-32)* is an excellent cautionary tale in how to properly determine reasonable compensation for a sole S corp shareholder-employee, and when it is and isn't considered reasonable not to pay yourself.

What is Reasonable Compensation?

Reasonable compensation is the amount that S corporation must pay an owner-employee in W-2 wages for their services before non-wage distributions (dividends, the distribution of profit) are considered.

The IRS retains the right to reclassify any payments made by an S corporation to be salary payments that should have been reported on Form W-2 instead of dividend income that is not subject to payroll taxes. The Tax Court case Joly v. Commissioner *(T.C. Memo. 1998-361)* is what ultimately held up this authority, and it has been used in numerous examinations ever since.

What makes compensation "reasonable" ultimately depends on the unique facts and circumstances of the business. For instance, it would be reasonable for a new business that must undergo a great deal of market research and permit requirements before accepting paying customers to not pay the owners salaries until revenue has materialized and stabilized. If a self-employed software engineer would typically earn $100,000 per year at a comparable employer but has only made $50,000 in contract revenue and wants to reinvest some of their profits in new equipment and marketing, a $30,000 salary could be seen as reasonable for those circumstances.

The IRS uses three criteria to refine what reasonable compensation is:

1) The type of services the shareholder-employee performs
2) If any services are performed by employees who are not shareholders
3) How much profit is allocable to capital and equipment

Essentially, profit generated from non-shareholder employees' services and that can be traced to equipment and other capital assets would be classified as non-wage payments. However, services directly connected to the shareholder-employee would be considered compensation that must be reported on Form W-2.

For S corporations with just one shareholder, the IRS tends to strictly look at the total revenue and whether the shareholder took a salary at all, followed by that salary proximal to revenue. Other factors that would be considered for reasonable compensation would include comparable salaries at larger companies, if the shareholder has previous experience in their field and how much, additional credentials and training, and how much time the owner devotes to the business.

Lateesa Ward v. Commissioner: Minor Services vs. Services Essential to the Company

Lateesa Ward is a self-employed attorney with her own firm, Minneapolis-based Ward & Ward Company, that has operated as a sole shareholder-employee S corporation since 2006 with one associate attorney as an employee. The IRS audited Ward's business and personal tax returns for the 2011-2013 tax years. The firm reported a loss of $1,373 in 2011, with $62,388 in officer compensation to Ward and wages to the associate attorney of $33,925. However, the payroll tax return only reported $41,483.78 and Ward's personal tax return only reported the business loss and not the wages she received.

There were similar misreporting issues for 2012 and 2013 as well, but Ward challenged the Commissioner's assertion that she failed to report and pay taxes on the compensation her own firm paid her. Ward claimed some of the compensation she received was salary, but that the rest constituted distributions of the profits.

Given that Ward had been a practicing attorney for 15 years prior to opening her own firm where she is the sole owner and officer, the Court found that there was no evidence to support that the payments she received were anything BUT officer compensation. Ward was instrumental in providing legal services to the firm's clients, and did not leave most of the operations to the associate attorney on payroll. Had she only provided a minor degree of services, such as owning or another business or still being employed by a larger firm, it's possible that the Court may have given her more of a reprieve.

There are many takeaways from this case for solo S corporation owners to think about. Ward's level of experience and mismanagement of her personal tax matters worked against her in Tax Court in arguing how much of her compensation should have been treated as salary. While salary payments can be deducted from an S corporation's profit, and even lead to a loss, they still need to be properly reported on your individual tax return. Moreover, the fact that Ward devoted all of her attention to her business as the sole owner and officer combined with comparable salaries for attorneys in the Minneapolis area were key deciding factors in the Court determining how much of the money received was a salary and not a dividend.

Jeff Lipsey and Associates can assist small business owners with determining the right business entity for their needs and making an accurate determination with respect to reasonable compensation. Contact us today to speak to one of our friendly and professional business tax experts.