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MEMO ON S CORPORATION TAXES -2005

There is a lot of controversy about S corporation taxation and I hope to be able to clear up some of that in this memo.

This is going out to all clients so that you can both understand the issues and advise your accountants accordingly. You have my permission to show them this memo.

...

When you receive your S corporation status from the IRS, it comes with a statement something to the effect that “we expect you to have a reasonable salary if you are an owner/operator of an S corporation.”

A “salary” is subject to a 15.3% FICA tax as is self-employment income (SECA). The government has an interest in collecting this tax as it is what helps pay for social security benefits.

However, distributions (profits, withdrawals, income) from an S corporation are not “salary” according to the IRS’s own ruling. (See Revenue Ruling 1959-IC.B22). What is going on?

To confuse things further, some accountants insist that the beginning S corporation owners start off with a salary, I suppose because they take the IRS statement as a warning or a red flag for an audit.

I hope to show you a more reasonable way to look at this situation.

...

Some simplified definitions:

Income Tax: after you have added up all of your taxable income and subtracted all of your deductions, credits, exemptions, etc., you pay income tax on what is left. The amount of income tax depends on how much is left after the math is done and on a variety of other factors. It is even possible to pay nothing under certain circumstances.

Taxable Income: any salary, dividends, distributions from partnerships or S corporations, rents, social security (sometimes), interest payments, capital gains received by you. This does not include gifts you receive.

SECA Tax: Self employment tax is 15.3% *in addition to* your income tax on your *net* self-employment income up to a certain amount ... currently \$90,000. If you had \$90,000 of net self employment income, you would pay an extra \$13,770 in SECA tax after you had paid your income tax on the same \$90,000.

Self Employment: If you work as an individual (not as an employee of a corporation or a limited liability company), or are a general partner in a partnership, all of the income you earn is subject to SECA tax up to the current limits, according to the IRS. If you are a limited partner – one with no management responsibilities – you are not deemed to be “employed” and therefore owe no SECA tax - you are not a general partner.

FICA Taxes: Often called “payroll taxes” – the same 15.3% tax as the SECA tax, but it is a tax on your salary or wages from your employer up to the current limit.

Employee: an individual who receives a salary or wages or other contractual compensation from an employer (if you are self-employed, you do not have an employer.) It is possible to be the sole owner of a corporation or an LLC (the employer) and be an employee as well.

...

As most of you know, LLCs can be taxed as a corporation - as either an S or C corporation.

A C corporation is a separate taxpayer and if it makes a profit, it pays a tax. If it pays income to the owners, it comes to them as either a salary or bonus both of which are subject to FICA tax and deductible by the corporation, or as a dividend, which is not FICA taxable to the owner, but also not deductible by the corporation.

C corporations are extremely valuable when the owners have special or extraordinary

medical needs... you might want to see my book or call me for those details.

An S corporation pays no tax itself, but passes on its profits or losses to its shareholders in proportion to their ownership percentages.

A Limited Liability Company with one member starts off being taxed as an individual, as a self employed person. If there is more than one member, the LLC is taxed as a partnership, as a group of several self employed persons, which is the reason we usually change the taxation of a new LLC from this default taxation to S corporation taxation. I often say that the self-employed person pays the highest tax in the very small business and some of this can be avoided by the change in taxation.

We do not change the taxation of an LLC that is holding real estate because the sale of real estate creates a separate (extra) tax in any sort of corporation that can be avoided if the LLC is taxed as an individual or a partnership is taxed. In addition, rents are exempt from FICA or SECA tax.

I like the LLC structure because it is both simpler and more versatile than the corporate structure, but I also like the S corporation taxation because it can save taxes.

In an S corporation, all of the profits and losses are credited to the owners at the end of the year in proportion to their ownership. Profits and losses are calculated after expenses. Including salaries and these profits are not subject to SECA (or FICA) taxes. (Again, see Revenue Ruling 1959-IC.B22).

However, as an owner-operator of a company that is taxed as an S corporation, the IRS wants you to be an employee and have a “reasonable salary”...a “salary” is payroll compensation which is subject to an additional 15.3% FICA tax.

This is a legitimate requirement. It is a requirement to use our reason to establish our employee relationship to our company if we work for the company, and should not be perceived as an adversarial demand.

Remember that the “reasonable salary” only applies to the owner-manager... not necessarily to the spouse who has a one-half interest in the business but does no work for the company, or to the passive investor who owns 80% of the company.

The question remains: What constitutes a reasonable salary for an owner who is also working in the business? An owner who is not working in the business will receive only the percentage of profit that is his/her due, but the IRS wants the working owner to have a reasonable, FICA taxable, salary.

Reasonable compensation is not defined by law, except to say that the amount of compensation is to be “based upon the relevant facts and circumstances.”

How much would you have to pay to an outsider to do what you do? That would be a good rule for an established business that could afford a good fat manager's salary, but what about most of us very small businesses, barely getting along? I think these businesses need a different measurement of "salary" because the facts and circumstances are different.

A salary is a contract between the company and the employer. A company that is struggling cannot afford to contract with anyone for a specific salary until it gets on its feet, so I think that, until the company has a predictable cash flow, it should certainly have no owner- employees on salary.

An owner- employee might take out some income one month, only to have to put it back the next... but do not complicate things by calling the money you take out a salary and yourself an employee until you know you can keep it!

In most cases I suggest that, First, at the end of the tax year, the owners of very small businesses sit down and decide how much income, based upon the track record of the past year, the company can reasonably be expected to generate as profit.

Second, set aside a part of that projected profit for expansion, including hiring of employees other than yourselves.

Third, set a reasonable salary for yourselves, making certain the salary is not too generous so that, in the case of an emergency or set-back, you have not over-promised on fixed costs such as salaries.

If things are better than expected you should consider adjusting your salary for the next year, meanwhile, you will not be pinching yourself for money as you can always give out non-FICA distributions when you have the money.

An Example:

Year One: Mary sits down at the end of the tax year and writes down the following summary of her planning for her eight month old business (an LLC taxed as an S corporation)...

"We have had a good start with gross revenues of \$35,000 this year, which was \$10,000 higher than we projected, however our expenses were \$3,000 higher than anticipated - a total of \$12,000 - and we already need to invest at least \$5,000 in additional computer equipment next year.

"If we hire another employee which we will need if this growth continues, that will cost

at least \$25,000 in salary and more equipment, so the expenses for next year should be at least \$42,000, and this more than we made this year.

“However, I am hopefully projecting gross income to continue to grow at the pace it has been growing in the last four months and, if that happens, we should have revenues of \$75,000, and a gross profit of \$33,000. I will have to pay taxes on this profit, but most of the money will have gone into paying other non-deductible expenses such as inventory and loan principal payments and will not come to me.

“It is far too early for me to commit to a salary for myself, I still owe the bank for my start-up money, and I have been living on that and my home equity loan.”

Year Two and Three: Growth continues, but expenses more than keep up with the growth. As is the case with most businesses, the expenses of growth make it difficult to have working capital on hand and the original loans increase, rather than diminish.

Mary is not able to commit to a fixed salary for herself and the “profit” she pays tax on at the end of each year is taxed as a distribution and not as FICA taxable income, which is just as well because she sees little of this profit in her pocket.

In Year four, Mary has her growth in control and can predict her revenues and expenses as both growing at a comfortable 10% per year. In December of that year she decides that she can give herself a salary of \$25,000 for year six.

...

My simple proposal is that we who are taxed as S corporations should write down our thoughts and plans at the end of each year, giving a copy to our accountants, so that, if anyone asks why we did or did not establish a salary for ourselves in such-in-such year, we can demonstrate what the “relevant facts and circumstances” were at the time.

We should set our salaries for the next year (if any) at the end of the previous year and stick to this all year, unless it becomes too expensive for our business to continue paying the salary.

A handwritten signature in black ink, appearing to be a stylized 'M' or similar character, located at the bottom center of the page.