

Webinar Slides

Why S-Corps Don't Always Save Money

Presented by:

R. Joseph Ritter, Jr., EA CFP®
Somerset Tax Partners, LLC

Married Filing Jointly

Schedule C

Gross Income	\$80,000
One-Half of SE Tax	-\$5,652
Standard Deduction	<u>-\$24,400</u>
Taxable Income	\$49,948
QBI	-\$9,990
Taxable Income	\$39,959
Total Tax	\$15,699

Single or Married Filing Separate

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Gross Income	\$80,000
One-Half of SE Tax	-\$5,652
Standard Deduction	<u>-\$12,200</u>
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QBI	-\$12,430
Taxable Income	\$49,719
Total Tax	\$18,100

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Individual Taxable Income	\$45,630
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Gross Income	\$74,225
Standard Deduction	<u>-\$24,400</u>
Taxable Income	\$49,825
QBI	<u>-\$845</u>
Individual Taxable Income	\$48,980
Individual Tax	\$5,450
Net Profit	\$80,000
Business Tax	\$0
Reasonable Salary	\$70,000
Payroll Tax	\$11,060
Total Tax	\$16,510

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Standard Deduction	<u>-\$24,400</u>
Taxable Income	\$49,825
QBI	<u>-\$845</u>
Individual Taxable Income	\$48,980
Individual Tax	\$5,450
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Reasonable Compensation

Reasonable compensation is generally the amount that would ordinarily be paid for similar services by similar enterprises under similar circumstances. The reasonableness of compensation is determined on the basis of all the facts and circumstances. *Pacific Grains, Inc., an Oregon Corporation, Petitioner v. Commissioner of Internal Revenue, Respondent*, 68-2 USTC ¶9536

Caution

Failing to pay a reasonable salary to S-Corporation shareholders who also provide services to the entity can result in an assessment of payroll taxes for any prior quarters in which the compensation should have been paid – plus penalties and interest for the unpaid payroll taxes.

Bonus Material: Determining What Is Reasonable

Multi-Factor Approach

Under a multi-factor approach, the determination of reasonableness includes, but is not limited to, a number of factors.

1. The employee's responsibilities and duties in the organization, including:
 - the type and extent of the services rendered;
 - the employee's qualifications;
 - the hours worked and duties performed; and
 - the employee's importance to the company's success.
2. The prevailing compensation paid to employee's by similar companies in similar industries for similar services.
3. The scarcity of qualified employees.
4. The salary history of the employee receiving the compensation.
5. The company's characteristics, including:
 - its size as indicated by its sales or capital value;
 - the complexities of the business;
 - the general economic conditions; and
 - any peculiarities of the business.
6. Whether the relationship between the company and the employee whose compensation is at issue might permit the company to disguise non-deductible corporate distributions of income as deductible compensation. A potential for this kind of abuse exists when the employee is the company's sole or controlling shareholder.
7. Whether the compensation is paid pursuant to a structured, formal, and consistently applied program. Bonuses not paid pursuant to formal plans are suspect.

Independent Investor Test

Under the independent investor test, the reasonableness of compensation is assessed in terms of whether an independent investor would be willing to compensate the employee as he was compensated. This is not a separate, autonomous factor under the multi-factor test. Rather it provides a focal point for the entire analysis.

The starting point for independent investor analysis is generally the company's rate of return on equity and how that compares to the rate of return on other investments of similar risk. Thus, an employer seeking to justify compensation as reasonable must show:

- the amount of equity the company has in the year of compensation,
- the investment return in that year, and
- a comparable benchmark rate of return.

S-Corporation Basis

Basis = The cost of acquiring property.

In an S-Corporation, it is the shareholder's initial investment –

Plus, the shareholder's portion of income

Minus, distributions to the shareholder

Minus, the shareholder's portion of losses and deductions

Caution

Basis in an S-Corporation cannot go below zero!!

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Individual Taxable Income	\$20,600
Individual Tax	\$2,087
Net Profit	\$31,288
Business Tax	\$6,570
Salary	\$45,000
Payroll Tax	\$7,110
Total Tax	\$15,767

Single or Married Filing Separate

C-Corp

Gross Income	\$45,000
Standard Deduction	<u>-\$12,200</u>
Individual Taxable Income	\$32,800
Individual Tax	\$3,745
Net Profit	\$31,288
Business Tax	\$6,570
Salary	\$45,000
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Total Tax	\$17,425

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Individual Tax	\$2,087
Net Profit	\$31,288
Business Tax	\$6,570
Salary	\$45,000
Payroll Tax	\$7,110
Total Tax	\$15,767

Married Filing Jointly

S-Corp

Gross Income	\$76,288
Standard Deduction	<u>-\$24,400</u>
Taxable Income	\$51,888
QBI	<u>-\$6,258</u>
Individual Taxable Income	\$45,630
Individual Tax	\$5,087
Net Profit	\$80,000
Business Tax	\$0
Reasonable Salary	\$45,000
Payroll Tax	\$7,110
Total Tax	\$12,197

Single or Married Filing Separate

C-Corp

Gross Income	\$45,000
Standard Deduction	<u>-\$12,200</u>
Individual Taxable Income	\$32,800
Individual Tax	\$3,745
Net Profit	\$31,288
Business Tax	\$6,570
Salary	\$45,000
Payroll Tax	\$7,110
Total Tax	\$17,425

Single or Married Filing Separate

S-Corp

Gross Income	\$76,288
Standard Deduction	<u>-\$12,200</u>
Taxable Income	\$64,088
QBI	<u>-\$6,258</u>
Individual Taxable Income	\$57,830
Individual Tax	\$8,580
Net Profit	\$80,000
Business Tax	\$0
Reasonable Salary	\$45,000
Payroll Tax	\$7,110
Total Tax	\$15,690

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Piercing the Corporate Veil

Liability is generally contained within an entity. However, both courts and taxing authorities (e.g., IRS) have the power to pierce this veil of protection and assess liability against the shareholder.

The IRS could levy the personal assets of the sole shareholder of a corporation in order to satisfy taxes assessed against the corporation. Since the shareholders completely dominated and exercised control over the corporation, the corporation was actually the alter ego of the taxpayer. The taxpayer not only made all of the corporate decisions alone, but he also conducted all of the corporation's business through a proprietorship which he operated. This included the corporation's use of the proprietorship's banking account, telephone, credit and office. As the corporation and shareholder were in fact a single entity, the corporate veil could be pierced and the shareholder's property levied to satisfy the corporation's taxes. *U.S. District Court, Dist. Mont., Billings Div., Charles E. Wolfe, Plaintiff v. United States of America, Defendant*, 85-2 USTC ¶9476

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