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Architect **MONICA MASTRIANNI** says buildings have been thought of as disposable for two decades, but now people think it may pay off to use more durable goods. **4 >>>**

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BiS LEGAL ISSUES

IRS targets S corporations on employment taxes

In its continuing efforts to close the tax gap, the Internal Revenue Service may start pursuing some business owners for additional taxes.

A new report by the

Government Accountability Office, published in December, found that some S corporations are failing to pay adequate wages to their

owner-employees, which leads to an underpayment of employment taxes.

The tax revenue, penalties and interest the IRS could recover could be significant. Businesses designated as S corporations have grown in recent years with 4 million S corporations in 2006 accounting for total assets of \$3.3 trillion and \$413 billion in total net income.

Generally, S corporation income is subject to a single level of taxation, which

could mean lower taxes than a regularly taxed C corporation for many owners. Rather than taxing the net business income at the corporate level, individual shareholders are taxed based on their share of the net income.

Typically, owner-employees may receive both wages and distributions of profits, with only wages being subject to employment taxes. The IRS feels that some S corporations are inappropriately using this loophole to pay owner-employees artificially lowered wages to avoid paying employment taxes.

A GAO report found that about 13 percent of S corporations paid inadequate wage compensation in 2003 and 2004 to the tune of more than \$23.6 billion. Most of the underpayments came from S corporations with the fewest owners.

There is limited guidance on how to determine reasonable compensation. The IRS lists nine factors the courts

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have considered:

- Training and experience
 - Duties and responsibilities
 - Time and effort devoted to the business
 - Dividend history
 - Payments to non-owner employees
 - Timing and manner of paying bonuses to key people
 - Comparable business payments for similar services
 - Compensation agreements
 - Compensation formulas
- It is unclear whether future legislation may be enacted to close the loophole. The GAO report

suggested a new law could require a base employment tax liability for owner-employees on the company's net business income or levy employment taxes on all payments to active shareholders.

In both cases, one could argue that these payments have little connection to the value of the owner-employee's services.

This is an issue that S corporations should watch closely. The IRS is expected to issue additional guidance soon.

Meanwhile, business owners should be sure that they are paying,

reporting and withholding employment taxes on the appropriate amount of compensation for the jobs and services provided by owner-employees.

"Reasonable compensation" can be difficult to determine. S corporations and owner-employees should carefully consider — and be prepared to demonstrate — the reasonableness of an owner-employee's compensation based on the particular facts and circumstances and the nine factors outlined by the IRS.

If you have questions about the tax rules for S corporation owner-employees, you should consider contacting your lawyer or other tax adviser.

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