Young & Company, LLC

Accounting, Tax & Financial Services

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Using Comparable or Reasonable Wages in an "S" Corporation to Lower Overall Taxes

Knowledge – One of the Keys to Tax Planning Opportunities

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March 10, 2020

Re: ***"S" Corporations & Comparable or Reasonable Wages***

To Whom It Concerns:

Regardless of the size of your business or how it is structured, all business owners share one common partner: Uncle Sam. Virtually every business transaction has some tax consequence. A business transaction should never be looked upon solely on a pre-tax basis. It is only on an after-tax basis that a transaction should be viewed as good or bad.

The best way to deal with Uncle Sam is to arm yourself with knowledge. Simply stated, if you understand basic tax issues, you can avoid some basic tax problems. We want you to acquire the knowledge you need to effectively address certain tax issues.

We want to emphasize that the best way to look at Uncle Sam is as a partner who presents you with opportunities – in particular, opportunities for tax savings that can help boost your profits. The reason I say this is that I've seen too many small businesses let their concern about tax issues and fear of dealing with the IRS result in an ineffective or defensive tax strategy. By examining the tax law in light of both your responsibilities and the opportunities for tax savings, I hope to help you develop an offensive tax strategy that benefits both you and your business.

Our focus is on tax planning and we emphasize planning. Planning ultimately leads to action. If you have any questions about this or any other matter, please do not hesitate to call.

Sincerely,

Young & Company, LLC

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LEY/cya

What is an "S" Corporation?

It is a separate legal entity, just like any other corporation. The "S" election is a two page agreement *(Form 2553)* between the IRS and the shareholders as to how the profits or losses are to be taxed.

How am I taxed on the profits of the "S" Corporation?

The "S" election is treated as a conduit or flow-through entity. Profits and losses are computed, and the result allocated to the shareholders pro-rata to their ownership interest. After the corporate tax return is completed, each shareholder receives a Schedule K-1 showing their share. It is the figure on the K-1 that determines the taxable income, not the amount of money taken during the year.

Does an "S" Corporation pay income tax?

No. Not in the normal operating mode, meaning, doing what you do. If you are a plumber, the profits from plumbing pass through to the shareholder(s). If you sell an asset, such as a building and you are not in the business of selling buildings, then a tax may apply.

How much is the Self-Employment Tax on $50,000?

Let's assume we have self employed individual who makes $50,000 per year after all the normal tax angles like depreciation, auto allowances, etc.

He or she pays income tax on that amount. The amount of income tax is dependent upon marital status, number of dependents, other income, home mortgages, etc. The income tax is what it is. No matter how the income is changed *(from self-employment income to W-2 wages and income from an "S" Corporation),* the income tax is about the same. It's actually less with the "S" Corporation, yet not enough to discuss.

Self-Employment Tax is the self-employed person's version of FICA *(Federal Insurance Contributions Act)* which is divided into Social Security and Medicare. His or her self employment tax is about 14% of the $50,000, or $7,000. Remember, this is in addition to income tax!

You will not find 14% on any of the tax forms. It is actually 15.3% of 92.35% of the self employment income, with a deduction for one half of the self employment tax on the front of the tax return**. ON THE AVERAGE, IT'S 14%!**

Where is the Opportunity to Save Tax Dollars?

Let's change the nature of the income *(opportunity).* Assuming our self employed individual creates a separate legal entity *(incorporates)* and elects the "S" election ***(the key to this whole strategy)***, what would the overall tax effect be?

First of all, we have some new rules (responsibilities). An operating officer of a corporation must be on wages, period. *(Don't even think about whom the officer is versus the shareholder as a way to get around this rule).* How much should the wages be? The answer does not exist in the Internal Revenue Code, Regulations, or a chart anywhere. It is deemed to be a "Comparable or Reasonable Wage".

What are Comparable or Reasonable Wages?

Comparable or reasonable wages are the wages you would have to pay someone to do what you do. Let's assume you cut lawns. You have some great commercial contracts and you make $50,000 per year. Could you pay someone $10 per hour? Probably. If you work 40 hours per week, 50 weeks per year, that's 2,000 hours x $10 per hour equals annual wages of $20,000.

If less hours are worked due to cyclical fluctuations but $10 per hour is the going rate, the overall annual wage would be even less.

How Much Payroll Tax is Paid on Wages?

There are really three types of payroll taxes. FICA *(2 parts to it)*, Federal Unemployment and State Unemployment. Since we are giving an example of a new corporation, let's just assume that both unemployment taxes total $245 *(it may be less).* The FICA totals 15.3% of the first $127,200 in wages for 2017 (*2018 is $128,700*). As an employee, you normally see Social Security withheld of 6.2% and Medicare withheld of 1.45%, but that's the employee side of it. **The employer has to match this amount!** The Social Security portion stops at $127,200 but the Medicare portion continues on total W-2 wages.

Since we are talking about the owner who is now an employee, we really have to look at both sides of FICA.

FICA = $20,000 Wages x 15.3% =	$3,060
Unemployment Taxes (2)	245
Total Payroll Tax Expense	$3,305

Did I Save Money Yet?

Yes! It's the Difference between Self-Employment Tax at the individual level and Payroll Tax at the corporate level. In this example, it's $7,000 Self Employment Tax versus $3,305 Payroll Tax.

That's $3,695 of savings!

I Can't Live on the Wages of $20,000.

You don't have to. You take wages as any employee would. The corporation pays the payroll taxes on a monthly basis. The difference between the W-2 Wages of $20,000 and the total income of $50,000, is taken in the form of distributions from an "S" Corporation.

What Does My Tax Return Look Like Now?

We just took $50,000 of Schedule C Sole Proprietorship income, and put $20,000 of it as W-2 Wages and $30,000 of it as income from an "S" Corporation. It just goes on different lines of your personal tax return.

But I Still Work for Myself. Any Self Employment Tax?

Nope. You do not work for yourself. You are an employee of a corporation, which you just happen to own.

How Do I Take Dividends?

You don't. Dividends apply to a regular tax paying "C" Corporation. Dividends are taxed twice, once at the corporate level, and then again when the shareholder receives the dividend. Careful filing of the "S" election is critical to avoid "C" corporation status.

How Do I Take My Money?

Simply write yourself a check. Period. It's called a distribution. Generally, the only rule *(responsibility)* to be careful of is how distributions are made. They are made pro-rata to your ownership interest. If you own 60% and I own 40%, when we distribute $1,000, you must get $600 and I must get $400. Period. The checks have to be written at the same time. Period. We can not take it at different times**. Duck Rules Apply.**

What's this Duck Stuff?

In tax law, we say, **if it looks like a duck, and quacks like a duck, it must be a duck.** That's a part of your responsibilities. If it's a distribution, it must look like a distribution.

When it is annotated on your check stubs or in your computer register, simply explain it as a distribution. It is NOT a dividend, bonus, wage, or draw. Do not attempt to characterize it as a current distribution or distribution of prior profits, retained earnings, etc. It is a "DISTRIBUTION". Period. All those other explanations confuse the issue and may count against you in an audit.

If you do not adhere to the distribution rules, you didn't take a distribution. If you didn't take a distribution, the IRS would say you took wages. You don't want that. It would mean more payroll taxes, penalties, and interest. Quack, Quack. Everybody say Quack.

My Friend Has a "C" Corporation and They Pay No Corporate Tax by Taking Bonuses!

That's good. The U.S. Treasury thanks you for the extra dollars. Here's why. On the $50,000 in income that was paid out in the form of wages *(thus zeroing corporate income and paying no corporate income tax to either the IRS or State of Florida),* the corporation paid 15.3% in FICA totaling $7,650, plus a little something for unemployment tax.

Please Summarize the Three Alternatives

"S" Corporation Alternative: Shareholder pays income tax on $50,000. "S" Corporation pays payroll tax on $20,000. Payroll tax expense is $3,305.

"C" Corporation Alternative: Shareholder pays income tax on $50,000. "C" Corporation pays payroll tax on $50,000. Payroll tax expense is $7,650.

Self-Employed Alternative: Owner pays income tax on $50,000 and self-employment tax on $50,000. Self Employment tax is $7,000.

What Should My Comparable Wages Be?

Sorry, can't answer that with certainty. Each case is different based on the number of hours worked, what you would have to pay someone in that job, how high the skill level is, etc.

A rule of thumb: Pay at least what your highest paid employee is earning.

If you've figured out that having no wages saves a whole lot of money, think again. You'll get busted. Remember, you have a responsibility to be on wages.

Ever face the IRS on the issue of Comparable or Reasonable Wages?

We've been involved in audits wherein the IRS said wages of $30,000 was too low. It was a gas station management position. We showed the IRS *(not the auditor, but the supervisor when we did not agree with the auditor)* that the average station manager in the 400 stations in the southeast region of the United States makes $30,000 per year. It was on a major oil company's letterhead. We won. Case closed.

In another case, a professional took wages of $15,000. The IRS said the professional was supposed to take wages of $80,000. The professional said no, and argued the wages should only be $30,000. Industry literature backed this up, but was for staff positions, not seniors. The auditor settled on wages of $40,000. In this case, the taxpayer had to pay more, but only on wages of $40,000 for the last 2 years *(Statute of Limitations).* That's a lot of savings over the last 15 years!

Please notice that the Statute of Limitations can be utilized as a planning tool!

A Regular “C” Corporation pays tax at only 21%, but I’m at 24 to 37%.

That may be true. Some people would tell you that you can retain dollars in a regular “C” corporation and pay tax on it at a lower rate. That is absolutely true, but short sighted.

I do not know how, or when, but someday you will take those profits home. You may take them in the form of dividends, wages, bonuses, or from selling the business. The corporation has been taxed once, but, when you eventually take the profits home, you are taxed again and usually at a higher rate. That is called DOUBLE TAXATION.

Let’s say you personally are in a 12% bracket. Are you really? Pay 21% to IRS to IRS then you are taxed on remaining dividends at 0, 15 or 20%!

And, to further your regular “C” Corporation tax education, the State of Florida also gets 5.5% on income above $50,000 for calendar year 2019 & at the time of this writing we believe 4.458% for fiscal years ending in 2020. So, the IRS gets 21%, and the State of Florida gets 5.5% above $50,000. And then you pay on dividends!

Something else you should know. C Corporations have a schedule D for Long Term Capital Gains BUT there is no lower tax rate! That means those gains are taxed at ordinary rates (now 21%).

An “S” Corporation in the State of Florida does not pay a corporate income tax. The profits flow through to the shareholders, and the shareholders do not pay individual income tax in Florida. AND Long Term Capital Gains are treated at a lower rate when passed thru to the shareholders!

Should I Change to an “S” Corporation Now?

If you are a sole proprietor, yes. If you are a regular “C” Corporation and there are retained losses you may not want to change until those retained losses are offset by current profits. The losses stay with the regular “C” corporation. They are NOT passed thru to the shareholders. Additionally, you may have investors who could not legally participate in an “S” election.

Can I Change to an “S” retroactively?

No. Generally, the election must be made within 75 days of incorporating or within 75 days of the end of a fiscal year for it to be effective for the coming year. Depending on how long your existing “C” Corporation has been in existence, there may be some planning opportunities there. Strictly depends on the numbers as shown on prior corporate tax returns.

The Strategy

1. Take action immediately by incorporating with the "S" election.
2. Determine Comparable or Reasonable Wages.
3. File all government paperwork timely.
4. Hire an Accounting Firm that is both Efficient & Experienced.
5. By the way, our motto is…..

Efficiency & Experience Make Life Less Taxing ™

Pros and Cons of this Strategy

Pros

1. Save Over-All Tax Dollars.

2. Achieve some type of corporate protection. As accountants, we are not allowed to discuss legal liability issues since that comes under the auspices of attorneys. We can tell you, however, that we have seen many clients who were extremely happy that they were incorporated, and many who were very unhappy because they were not.

3. You actually pay less into social security. The money you save can be invested generally with a better return than investing in the social security system. Check for yourself.

   A. Obtain data on Form SS-7004 from Social Security Administration via SSA.gov (*easy to do*). This document is titled Request for Earnings and Benefit Estimate Statement. For purposes of this estimate, estimate your annual earnings at $50,000. You will receive a report that estimates how much social security you will receive.

   B. Compute a second Form SS-7004 with estimated annual earnings of $20,000. Compare the two. Every time we've had clients do this, they have agreed that the additional payments from social security with wages of $50,000 are not a good return when compared with investing the tax savings. In other words, is paying the extra FICA tax of $3,695 annually for the next 20 years worth receiving an extra $175 per month? That's the method. You have to check on your individual situation to make a determination.

Note: It is a good idea to periodically review SSA.gov to make sure all of your earnings have been posted.

Cons

1. You actually pay less into social security. That means you'll receive less when it is your turn to receive social security. Again, obtain Form SSA-7004 via SSA.gov and go through the calculations.

2. Some tax deductible items are no longer tax deductible or subject to limits.

   True. But, the over all effect of tax savings is usually well worth it.

3. If I die, since I pay less into social security, my kids would get less.

   Yes, that's true. How much less? You have to contact Social Security for a detailed explanation. We suggest clients purchase inexpensive term life insurance with a portion of their tax savings to more than cover this event.

   Let's say your children could receive $2,000 per month upon your death. Again, you have to contact social security administration. They are still going to collect something, but maybe not the full amount. Let's assume it's the whole difference of $2,000. It's not, but let's just assume it. They would collect $2,000 per month until they are 18. No more social security checks.

   If you purchased life insurance of $400,000 (*not taxable upon your death*) and were able to invest it at 6%, that's $24,000 per year, or $2,000 per month. BUT, after college, they still have $400,000 invested! No social security payments but $400k!

4. It **may** reduce the amount you can contribute to a pension.

   That is very complicated under new tax laws but they probably work to your advantage depending on how much you are able and willing to contribute to a pension.

   All pensions are based on earned income. Earned income is strictly your W-2 wages, not your total income from the "S" Corporation or any other source.

   A. **SEP**'s are up to 20% of your earned income (2020). Thus, if your wages are only $30,000, your contribution can be only $6,000. The maximum contribution under this plan for 2020 is a contribution of $57,000.

   B. Many other pensions are based on a percentage of earned income and may require employer contributions to other employees.

C. **Simple IRA**'s for 2020 would allow a contribution of up to $13,500 plus 3% of W2 wages assuming the employee contributed at least 3%. In this case, $30,000 x .03 = $900 from the employer, plus the employee portion of $13,500, for a total of $14,400 based on W-2 income of $30,000. Employees may contribute another $3,000 if over age 50. Again, this is complicated and there is a lot more to be said about this tax angle, but it can be done simply and without year end administrative costs.

D. With a **Solo 401(k)**, you can contribute up to $57,000 for 2020.

5. It's too complicated.

Actually, it's very complicated.

An accountant can help you file tax returns of all types.

A great accountant can help you save money and make the investment into his or her time well worth the effort.

Quack, quack!

Thank you,

Lonnie Young