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COLE SCHOTZ
COLE, SCHOTZ, MEISEL, FORMAN & LEONARD, P.A.

S Corporation Owners Must Take Reasonable Salary

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One of the benefits of an S corporation ownership structure is a payroll tax advantage. An S corporation owner will pay payroll tax on his or her salary, but not on the entire amount of corporate profit. For example, if a corporation's profit would be $500,000 without factoring in the owner's salary, and the owner takes $200,000 as compensation and shows $300,000 in profit, only the salary amount is subject to payroll tax. This is one of the benefits S corporations have over LLCs, where all company profit is considered self-employment income and subject to payroll tax. (A legislative proposal to change this treatment recently failed to pass.)

This advantage may encourage S corporation owners to take less in salary and more in profit so as to save payroll taxes, but a recent case [*David E. Watson, P.C. v US*, 107 AFTR 2d ¶2011-305 (S D IA, December 23, 2010)] shows that salary still must be reasonable.

David Watson, a CPA in Des Moines, Iowa, set up an S corporation which was a principal in a four member accounting firm. In 2002 and 2003, the accounting firm made profit distributions to Watson's S corporation of approximately $204,000 and $175,000 respectively. In those years, Watson reported a mere $24,000 of salary and the rest as S corporation profit, saving over $20,000 in payroll taxes.

The IRS disagreed with this reporting position, arguing that recent accounting graduates with no experience had average salaries at the time of approximately $40,000 per year, and that Watson's reasonable salary was approximately $91,000. The District Court for the Southern District of Iowa agreed, ordering Watson to pay back taxes, interest and penalties.

This case may be viewed as an IRS victory, and it demonstrates that S corporation owners must take a reasonable salary. Nonetheless, the case also demonstrates the benefit of the S corporation structure. Had Watson organized as an LLC, all of the profits distributed would have been subject to payroll tax.

Cole, Schotz, Meisel, Forman & Leonard, P.A.

Court Plaza North
25 Main Street
Hackensack, NJ 07601
Phone: (201) 489-3000

900 Third Avenue
16th Floor
New York, NY 10022
Phone: (212) 752-8000

500 Delaware Avenue
Suite 1410
Wilmington, DE 19801
Phone: (302) 652-3131

300 East Lombard Street Suite 2000
Baltimore, MD 21202
Phone: (410) 230-0660

301 Commerce Street
Suite 1700
Fort Worth, TX 76102
Phone: (817) 810-5250