

# S corporation officers: Are you taking a paycheck?



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If your company is organized as an S corporation, you may wonder whether it is better to take income from the company as salary or as cash distributions. Of the two options, distributions carry the least tax cost because they are not subject to employment taxes. However, that doesn't mean shareholders shouldn't take a paycheck from your company.

## IRS Warning

Over the years, the IRS has made a point of warning S corporations not to attempt to avoid federal employment taxes by having shareholders treat their compensation as cash distributions, payments of personal expenses, or loans instead of as wages. According to the IRS, distributions must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation.

## What Is a "Reasonable" Salary?

To avoid problems with the IRS, shareholders should be sure to take a reasonable amount of salary if they receive any direct or indirect payments from your company. However, the tax law has no hard-and-fast guidelines regarding what is considered "reasonable." When the issue has come up in court, the determination has been based on the facts and circumstances of the particular case. Various factors have come into play, including:

- > Duties and responsibilities
- > Time and effort devoted to the business
- > Training and experience
- > What comparable businesses pay for similar services
- > Timing and manner of paying bonuses to key people
- > Payments to employees who are not shareholders
- > The corporation's dividend-paying history
- > Compensation agreements
- > The use of a formula to determine compensation

## An Exception

What about an S corporation officer who doesn't perform any services for the corporation — or whose services are very minor? In this relatively unusual situation, assuming the officer receives no direct or indirect pay, he or she would not be considered an employee.

Your Baker Tilly tax advisor can help you evaluate an approach for salary or cash distributions that is based on every shareholder's unique needs, as well as factors that have been considered by the IRS.

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