Infobites: S-Corporations: Wages & Distributions

Background: When an S-corporation is formed, there are certain requirements when paying Shareholders. This Infobite is meant to provide an overview of the rules and considerations surrounding wages and distributions for Shareholder(s) of an S-corporation. One advantage of an S-corporation is to save on payroll taxes by paying distributions. A balance that is in-line with the regulations should be considered for wages and distributions.

Reasonable Wages vs. Distributions:

Shareholder(s) are "Employees" of an S-corporation. With this said, shareholder(s) should be paid a reasonable wage for the services that they are providing. It is very tempting to pay shareholders little or no salary and instead pay "distributions" because this avoids payroll taxes that the employee and company would avoid. This type of arrangement can end up in court with the IRS reclassifying distributions as wages. If this occurs, not only would the company be responsible for the payroll taxes associated with the reclassification but penalties and interest for underpayment and failure to file employment tax returns.

What is a reasonable wage? *[IRC section 3121(a)]*

Several factors can be used to assist the shareholders who are active in the company to determine a reasonable pay. A general rule of thumb is to look at what others in your industry would be paid for similar services.

Here are some factors that have been used in court cases in determining a reasonable wage. Each company should look at its unique facts and situation for determining a reasonable wage and how these factors would apply to their specific situation:

- The financial condition of the company
- The role the shareholder plays in the corporation
- How the wages compare to similar positions in other companies
- A comparison of salaries paid compared to the sales and net income of the company.
- Salaries compared to distributions and retained earnings (which is accumulated net income or loss of the company)

What if the S-corporation cannot afford to pay me wages?

If the S-corporation is in a situation that it cannot pay wages, then there is nothing that "forces" the company to pay wages that is cannot afford. The key here is that if wages are **not** paid then distributions **should not** be paid. Once the company is able to reasonable wages, then distributions can be considered.

What is a distribution?

In general, a distribution is a return of profit (or accumulated profit) from the company and is not taxable to the shareholder. An S-corporation is a pass-through entity and generally does not pay its own taxes. Instead, the shareholders pay the taxes on their individual tax returns. What this means is that each year, the shareholder receives a "K-1" which shows their "portion" of profit or loss of the corporation that is used in preparing their Form 1040 (Individual tax return). Even if the shareholder did not receive any cash (aka “distributions”) from profits from the company, it is reported and the Shareholder pays tax on it. A distribution is taking money out (when a company has a profit or accumulated profit). The shareholder is paying taxes on the profit so a distribution goes against the accumulated profit, so it is not taxable (unless you take out more than what you have made).

Example: Sue is the 100% shareholder for ABC Corporation (an S-Corp). For the current year, she has Net Income of $10,000. She paid herself a salary that is already included as an expense to arrive at the Net Income amount. She will report the net income on her individual tax return as “income.” She has taken $4,000 of distributions during the current year.

Accumulated Net income/loss	$2,000
Net income	$10,000
Distributions	($4,000)
Balance	$8,000

Note: If she took a distribution of $15,000, then $3,000 ($2,000 + 10,000 – 15,000) of the distribution would be **taxable** in addition to the net income of $10,000.

In a Nutshell:

- Review the rules for establishing a “reasonable” wage that each shareholder will be paid who is actively involved in the operation of the company.
- Once reasonable wages are established and paid, determine distributions to be paid and the frequency. Be careful not to take more distributions that profit or it will be taxable.

If you need further assistance this InfoBite, please call our office and we would be happy to assist you.