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# How S Corporation Owners Can Cut Taxes by Keeping a Lid on Their Salaries

***Estimated Tax Tip Savings:*** *Depending on your own salary and profit distribution levels, we're typically seeing cases in which the S corp. owner can legally slash personal payroll taxes by $8,000-$20,000 over the coming year.*

The number one way for S corporation owners to pay lower taxes is to set the right salary. To do this, you want to find your salary sweet spot—an amount that is low enough to save significantly on payroll taxes, but high enough to satisfy the IRS and avoid the risk of an audit.

Here's the principle: The lower you set your salary, the more you save in payroll taxes. However, if you set your salary too low, the IRS can step in, exposing you to back taxes, penalties and interest.

To protect your S corporation from IRS intrusion, yet maximize your take-home compensation, you need to follow the IRS guidelines for setting a reasonable salary. However, you won't find these rules anywhere in the tax code. The IRS invented this standard on its own, and, until recently, there was no consensus on how the IRS planned to act in this area.

Fortunately, three recent cases now give us a clear picture of the IRS's strategy. As an S corporation owner, you need to know these cases and use them as a guide when choosing and justifying your salary.

This article makes that process easy for you. We summarize the cases and then distill that information into practical steps you can take to protect your salary from IRS attack.

## *Cutting Payroll Taxes*

Consider this example to see how lowering your salary cuts payroll taxes. Let's say you operate a sole proprietorship and you earn $100,000 of business income. This means you pay $14,130 in self-employment taxes (the equivalent of payroll taxes).[1]

If you form an S corporation and set your salary at $50,000, you and the corporation pay a total of $7,650 in payroll taxes.[2] This gives you tax savings of $6,480.

What happens to your remaining $50,000 of business income? You can take that remaining $50,000 as a distribution, which is not subject to payroll taxes.[3]

## *The IRS Shows Its Hand*

Since the reasonable salary rule isn't part of the tax code, we have to gain our understanding from how the IRS implements the rule in practice.[4]

The next few sections summarize the three cases that best reveal the IRS strategy in this area. We then combine the lessons of the cases into practical steps you can take to safeguard your business.

## *Watson Fights the IRS*

David Watson was an accountant who operated through an S corporation. His S corporation was a 25 percent partner in an accounting firm.[5]

In each of the years in question, Watson's firm paid his corporation over $200,000, but Watson took a salary of only $24,000.

The IRS's valuation expert, Igor Ostrovsky, looked at statistics for what accountants earned in Watson's area of the country. He calculated a reasonable salary for Watson as $91,044, based on the following chain of logic:

- Ostrovsky first studied reports of accountant compensation, primarily the Management of Accounting Practice survey conducted by the American Institute of Certified Public Accountants.
- He determined that an employee with no investment interest would receive $70,000 in compensation.
- Since owners billed at 33 percent higher rates than directors, he adjusted the $70,000 upward by 33 percent.
- He then made a downward adjustment to $91,044 to factor in untaxable fringe benefits.

The court agreed with the IRS expert.

This wasn't all bad news. Even with a salary of $91,044, Watson could still take the majority of his income as distributions free of payroll tax, which gave him significant savings compared to what he would pay as a sole proprietor.

Of course, not all ended rosily for Watson. He had to pay $23,431.23 in unpaid payroll taxes, penalties, and interest.

## *McAlary Takes No Salary*

Sean McAlary was a businessman who decided to get into the real estate business a few years before the housing crash.[6]

He had quick success. In 2006, he took a distribution of $240,000 from his corporation. He did not take any salary, although the corporate minutes show he was entitled to receive a salary of $24,000.

The IRS consulted the same compensation expert as in the *Watson* case, Igor Ostrovsky. Using a similar method as in the previous case, Ostrovsky determined that the reasonable salary for McAlary should be $100,755:

- Ostrovsky consulted the California Occupational Employment Statistics Survey and found that the median wage for a real estate broker was $48.44 per hour.
- Ostrovsky multiplied $48.44 by 40 hours per week and 52 weeks per year (although the facts showed that McAlary worked 12-hour days with few days off).

Unlike in the *Watson* case, the tax court did not completely accept Ostrovsky's findings, stating that the calculation of reasonable compensation is "far from an exact science."

The court adjusted Ostrovsky's rate downward to $40 an hour, based on the idea that other factors contributed to McAlary's success beyond his own efforts, such as a favorable housing market.

Based on the $40 rate, the court set McAlary's salary at $83,200, leaving him with $156,800 of distributions for the year.

## *Blodgett's Salary Gives the Corporation a Net Loss*

Frederick Blodgett created glass blocks for windows, room dividers, skylights, and other real estate uses. In 2006, the construction industry in Southern California took a nosedive, and Blodgett's business suffered.[7]

In 2007 and 2008, he loaned about $55,000 to his S corporation, Glass Blocks Unlimited. In those two years, the corporation had net business income of $877 and $8,950, respectively.

Blodgett took no salary during that time, but he withdrew about $30,000 each year, which he reported as a mix of distributions and repayment of loans. However, the court found that the "loans" were actually contributions to capital and characterized 100 percent of the corporate payments to Blodgett as distributions.

The court upheld the IRS determination of Blodgett's salary as about $30,000 a year, finding that a person in Blodgett's line of work would make no less than that amount.[8]

**Note.** By assigning Blodgett a salary, the IRS and the tax court actually gave his corporation a net loss for the year.

## *Putting All the Cases Together*

When considering reasonable salary, your first step is to find reliable statistics regarding the wages for your job in your area of the country.

If you perform multiple jobs within your business or you aren't sure exactly how to classify your role, look for the closest comparison you can find.

Once you find a salary or wage comparison in the statistics, make reasonable adjustments based on the difference between your business and the average business. Here are some examples of why you might adjust the salary downward:

- Your business is less profitable than other businesses in the area.
- You don't work full time.
- Factors other than your personal efforts led to the success of your business, such as a favorable housing market for a real estate broker or the type of assets that you own.

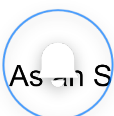
Document your reasons in your corporate minutes so that you have a record to prove your analysis.

## *Salary Red Flags*

The IRS is most likely to investigate compensation issues when the S corporation owner takes distributions but does not take a salary.

If your corporation is not making money, you do not have to take a salary.[9] However, if you don't take a salary, you should minimize or eliminate distributions until a year in which you do take a salary.

## *Takeaways*



As an S corporation owner, you cut payroll taxes when you reduce your salary.

The IRS allows you to use this tax-saving strategy as long as you do not drop your salary below a "reasonable" amount.

To determine a reasonable salary, follow these steps:

1. Look at salary statistics for your line of work in your area of the country.
2. Make downward adjustments to the statistical salary if you can justify them. For example, your business might be less profitable than average or you might work less than full time.
3. Document your analysis in your corporate minutes.

Last, remember this rule—if you do not take a salary, do not take distributions. Taking distributions without salary puts you squarely on the IRS radar.

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1 Self-employment tax rate of 15.3 percent is applied to 92.35 percent of the $100,000 of self-employment income, for a net self-employment tax of $14,130. See Schedule SE for the 92.35 percent.
2 $50,000 x 15.3 percent.
3 Rev. Rul. 59-221.
4 See IRS Fact Sheet 2008-25.
5 Watson v US, 668 F.3d 1008 (8th Cir.).
6 Sean McAlary Ltd, Inc., TC Summary Opinion 2013-62.
7 Glass Blocks Unlimited, TC Memo 2013-180.
8 The court discussed an hourly rate for Blodgett, but the judge did not do a full salary analysis in this case, unlike the courts in previous cases. This might be due to the fact that Blodgett's business had so little net income. The court decided that the distributions Blodgett took were at least as much as a reasonable salary.
9 See Davis, d/b/a Mile High Calcium, Inc. v US, 74 AFTR 2d 94-5618.