

### **To all clients operating in an entity taxed as an S-corporation:**

Each year companies operating as an S-corporation expose themselves unnecessarily to deduction disallowance or income inclusions by the IRS. This letter outlines the most common problems, and easy steps to take to remedy the situation going forward. If you recognize any of the following in your business, please take the recommended corrective action immediately or contact our staff for more information.

- **Taking draws or distributions whenever needed, without declaring them in the corporate records**
- **Failing to take wages (payroll) when the company has some (even minor) taxable profits before “draws”**
- **Lending or borrowing money without loan documents**
- **Paying for vehicle fuel, insurance, etc. from the company account when a vehicle is personally owned.**

Let's review each topic separately here, and explain where the exposure is and what can be done to minimize it.

### **S CORPORATION DRAWS OR DISTRIBUTIONS**

Almost all start-up S-corporation owners initially attempt to take pay from the business by paying themselves a “draw”. They believe that by doing so they are avoiding the hassle of payroll tax return filings and tax deposits. If they had operated initially as a sole-proprietor, after all, this was a quite acceptable practice. This, however, was because, as a sole-proprietor, ALL net profits were subjected to the 15.3% “Self-Employment” tax. Now, however, as an S-corporation shareholder, such “draws” escape that 15.3% tax. (Yet another justification to make all pay self-employment tax exempt “draws”, right?)

While it IS a tax planning technique to maximize draws and minimize payroll, it must be done carefully and with adequate support. The IRS is well aware of this technique, and just this month labeled it a “questionable practice” in its practitioner’s newsletter.

To be properly labeled a “draw” or “distribution”, several factors must be in place:

**First**, there must have been adequate compensation previously paid (i.e. payroll) to the owner for all services rendered. What is “adequate”? The IRS requires that owners be paid wages (requiring payroll tax filings) which are equivalent to what one would pay an unrelated party (and wages, of course, which that party would deem adequate) to perform all of the services, including managerial and administrative, that are rendered. If wages

aren't paid at all, there cannot be "draw" in the eyes of the IRS, unless the owner is totally separate from the business, rendering absolutely no services (i.e. purely as an investor and not involved in any business decisions or activities).

**Second**, if there is more than one shareholder, you MUST make "draws" pro-rata overall. That means if you pay a \$400 distribution to a 40% shareholder, you must make a \$600 distribution to the other 60% shareholder, assuming there are only two shareholders.

**Third**, to pay "draw" or "distributions", there should be a corporate meeting at which the directors/shareholders vote (and record that vote) to make a profit distribution to shareholders. Note the distinction between "draw" and wages. "Draw" properly reflects a distribution of excess profits after reasonable wages have been paid to all employees, including shareholder/owners. "Draw" is not payment for services.

### **FAILURE TO TAKE WAGES**

This above topic blends smoothly into the second topic – failure to take wages. As noted above, the IRS looks for adequate wages to be paid. In the S-corporation environment, they are always looking for under-compensation. Should they find it, the tax consequences can be devastating. Failure to file payroll tax returns and withhold and pay payroll taxes can lead to significant penalties (in fact, it is the number one area in which penalties are assessed) and, coupled with interest over years of non-compliance, these assessments can easily put a company out of business. Therefore, getting on track quickly is in your own best interest.

While complying with the payroll tax laws can be confusing, it is not difficult. For most businesses, however, their time is better spent on their business itself, so the best way to comply, in my opinion, is to completely hand over the compliance to a competent bookkeeper. Let me know if you need a good recommendation in this area.

Tax professionals are divided on their opinion as to how aggressive the IRS will be in seeking out inadequate compensation. Some believe they are blowing smoke, while others believe enforcement efforts will increase in this area in future years. We lean more toward those that believe enforcement will increase, however we also believe this factor, in and of itself, may not cause an audit. Rather, we believe that during an audit, it is an issue which is far more likely to be scrutinized than ever before. Here's why. In 2002 an internal IRS memo suggested that the IRS begin auditing all S-corporations which showed \$10,000 or more in net profits, before "draws", with no payroll to the owner providing services. However, we am not aware that they have (as of yet, anyway) begun that initiative. However, more recently, a court case was decided last year (*Nu-Look Design, Inc. v. Commissioner*) in which the IRS successfully argued that "draws" of \$10,866.14 in 1996, \$14,216.37 in 1997, and \$7,103.60 in 1998 were in fact disguised wages! Note that here NO wages were paid, and small profits were "drawn". The danger in this case is, of course, that if adequate wages are not paid, it is entirely possible that ALL profits "drawn" may be reclassified as wages.

The amazing thing here is that the IRS went after **such a small taxpayer**, for peanuts! They incurred the cost (as did the losing taxpayer to fight it) to establish a legal precedent, which, of course, may now be used against other mom and pop businesses. **The old argument “I’m too small for them to go after” obviously no longer applies.**

### **LOANS TO OR FROM BUSINESS**

Let’s now look at loans to or from the business. Here again, the IRS likes to reclassify “loans” as taxable wages, or, in the case of loans to the company, (non-retrievable) capital contributions. How do they get away with this? Well, actually, it’s easy. You see, all the IRS has to demonstrate is that you didn’t really treat it as a loan - that is to say you never drafted up a legal loan document, never charged a fair interest rate, and/or never made regular payments against the “loan”. Hence, you never really meant it to be a loan! The easy way to prevent this type of problem is to draft a loan document, have me prepare a re-payment schedule, including interest, and stick to it. Then the IRS doesn’t have a leg to stand on!

### **EMPLOYEE / OWNER EXPENSE REIMBURSEMENT**

Finally, and widely prevalent, is reimbursing owners and employees for business expenses incurred by the individuals. Frequent on this list are cell phones and automobile mileage reimbursements, among others. While there is nothing at all wrong about making such reimbursements, it is essential that proper tax protocol be followed to avoid having these reimbursements taxable as wages. Generally, the IRS considers all payments made to employees to be wages. Certain limited exceptions do apply, however, the most important of which may well be the Accountable Reimbursement Plan.

Unless the company has established an Accountable Reimbursement Plan **in writing** which meets several IRS requirements, reimbursements to employees or owners (over 2% owners are deemed employees under tax law) are considered wages, subject to the normal payroll tax withholdings. The resulting reimbursements are properly reported in Box 1 of Form W-2 along with normal wages. However, for those companies which have adopted an Accountable Reimbursement Plan, these payments remain a tax deductible expense for the company, and are received totally tax-free by the employee.

To be an Accountable Reimbursement Plan in the eyes of the IRS, the plan must be in writing, must require that proof of business expense be presented to (and retained by) the corporation within 60 days of the expenditure, and must require that any excess paid to the employee (i.e. in the form of an advance) must be returned to the company within 60 days. Of course, the corporate minutes should reflect the authorization and adoption of the Accountable Reimbursement Plan.

Often, businesses use a **personally owned** vehicle for company business. Many times, the company pays many of the vehicle expenses, often including fuel, insurance, loan payments, etc. **THESE PAYMENTS ARE WAGES, NOT REIMBURSEMENTS**, as the company doesn't own the vehicle, the individual does! Each such payment is required to have taxes withheld, and be included in the employee's W-2.

When reimbursement payments are made without having to account for the business use of the vehicle or other expenditure, it is referred to as a **“non-accountable plan”**. Payments made from a non-accountable plan are includable in wages, subject to all normal withholding, and may be deductible on the owner/employee's personal Form 1040, using Form 2106, to the limited extent allowable by law. The easy solution here is to adopt the written plan.

Of course, you could put the vehicle in the company's name. Your insurance premiums may rise, but if it is used 100% for business the company could pay all of the expenses on its vehicle directly. Any personal use would need to be reported on the owner/employee's Form W-2 as wages, however. Mileage records are required in either circumstance, so overall recordkeeping doesn't change.

## **CONCLUSION**

As you can see, proper planning can allow favorable tax treatment or avoid unpleasant surprises upon IRS audit. Therefore, please “fine-tune” your recordkeeping where necessary. Please review your reimbursement plan and adopt any changes which may be necessary to assure maximum tax benefits for reimbursements.

Our staff is available to answer any questions you may have on these and other issues, so please do not hesitate to call.

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