

2009/2010 S-CORPORATION UPDATE

Due to increasing scrutiny of S Corporations by the Internal Revenue Service (IRS), below are a few items for you to consider as you carry out your day-to-day business activities. The increase in scrutiny is primarily a result of the vast number of small businesses electing this entity for favorable tax treatment. As a result, we anticipate more IRS audit activity in this area. Below are a few IRS “hot button” issues for you to consider. If you have any questions or concerns as to how this impacts your Company or would like further advice on the topic, do not hesitate to contact us.

Reasonable Compensation

The IRS, in recent S Corporation audits, is asserting its authority to re-characterize dividends into ‘more reasonable’ compensation in an attempt to increase the amount of self-employment tax paid by the S Corporation. At present, the IRS has made it clear they intend to more aggressively challenge the level of compensation S Corporations shareholders are paying themselves.

Generally speaking, shareholders should pay themselves reasonable compensation for services they provide their company. This compensation is subject to employment taxes. In many instances, shareholders are paying themselves significant dividends and little or no salary. In such cases, they run the risk of the IRS re-characterizing such payments as salary, subject to income and payroll taxes in addition to late payment interest and penalties. “Reasonable compensation” is subjective in nature and must be analyzed based on a company’s particular facts and circumstances. As an aid, consider using www.salary.com or a similar source as a benchmarking tool.

Health Insurance Premiums for Shareholders

IRS Notice 2008-1 provides rules under which a 2% or more shareholder-employee in an S Corporation is entitled to the deduction for accident and health insurance premiums that are paid or reimbursed by the S Corporation for documented premium payments. The notice did clarify in a taxpayer favorable move that the policy can either be in the name of the company or in the name of the shareholder with reimbursements made to the shareholder.

In order for the shareholder-employee to deduct the premiums above adjusted gross income (as opposed to itemized deductions on Schedule A), such premiums must be included Box 1 taxable income, but not in Box 3 or Box 5 as wages for FICA and Medicare tax as well as included in other requisite payroll tax filings. The shareholder-employee must then report the W-2 income on their personal return with an offsetting deduction for self-employed health insurance premiums on line 29 of the Form 1040. If the insurance premiums are not included in the prescribed way on the Form W-2, S Corporation shareholders cannot deduct the health insurance costs above AGI but rather must report them as an itemized medical deduction on Schedule A.

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Accountable Plans

An important item to remember is that business expenses incurred and paid by shareholders personally, should be reimbursed by the Company during the same year incurred to satisfy the “accountable” plan rules. Expenditures may include, but are not limited to, office supplies, travel expenses, meals and entertainment. Amounts paid under a “non-accountable” plan would be included in the employee’s gross income for the taxable year, subject to withholding and employment taxes and the deductions would be claimed on the employee’s individual tax returns subject to certain limitations. As it is not only tax advantageous but good business practice to set-up an accountable plan policy, we recommend implementing this policy immediately.

Shareholder Loans

It is not uncommon for shareholders to loan personal funds to their S Corporation on either a temporary basis to fund operations or a permanent basis in the form of long-term financing. In such cases, since the shareholder is personally at-risk for the loaned amount, tax rules consider this “debt basis” which allows the Company to pass through losses to the shareholder that can be claimed on the shareholders personal income tax returns. Similar financing by the company obtained through another source (i.e. bank debt), even if personally guaranteed by the shareholder, doesn’t give rise to debt basis and therefore cannot be utilized to pass through losses to the shareholder. To substantiate any shareholder loan as a bona-fide loan, the loan should in all cases be evidenced by a signed promissory note that bears a market rate of interest and is subject to terms and conditions equivalent to those an independent third party would provide.

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