#1 AUDIT RISK for Corporations -- "zero payroll"

The number one audit risk for an active Corporation is zero salary and wages reporting. The IRS also pays particular attention to the salaries paid to a corporation's officers. While the IRS says that all corporate officers must be paid a salary, they also have their own ideas of how much those officers should be paid.

Here are the scenarios that the IRS will be looking for:

No compensation. If a corporation shows no compensation to its officers the IRS will take notice. They want all corporate officers to receive salaries because no salaries mean no payroll taxes and less revenue to the government.

Compensation that is too high. If you are a shareholder-officer of a professional corporation (PC) the IRS will be watching to make sure your salary is not too high. Higher salaries mean lower (or no) profits. The IRS does not like this because they want PCs to show profits and pay taxes on those profits. PCs pay a tax on their profits at a flat rate of 35%.

Compensation that is too low. The IRS looks for excessively low salaries paid to working shareholders of S-Corporations. Lower salaries mean higher profits, and these profits (which are taxed directly to the shareholders) are not subject to the payroll taxes that normal wages are.

What's a Reasonable Salary?

Compensation of shareholder-employees should be based on the same criteria as salary for non-shareholders. Factors would include prevailing market rates; the individual's knowledge, skills, and abilities; amount of hours worked; and so forth. Salary is reasonable if a non-shareholder would be willing to accept the job at the proposed salary level.

Generally, the IRS will grant the S-Corporation a degree of latitude in setting salary compensation for shareholder-employees. However, the salary must be paid, and the level of salary must be appropriate.

It is assumed by the IRS that no one works for free, and so the IRS has said over and over again that officers of the corporation must receive wages. As an owner-employee of a Corporation, you must pay yourself a salary, and pay payroll taxes on your salary, even if the business is losing money. You don't have to pay yourself a high salary, but it must be a "reasonable amount" according to the IRS.

Reasonableness can be interpreted in different ways. I would keep track of the number of hours you work for your business, and then figure out a "reasonable" salary to pay yourself based on the amount of time you spend.

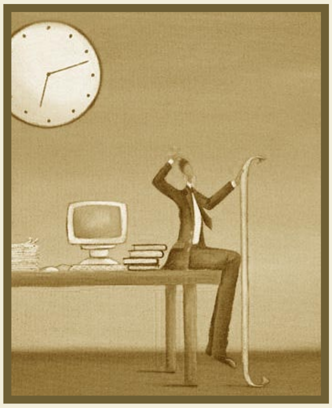
If your company is losing money (especially in the first few years of operation), then your losses will be exaggerated by the salary you have to pay yourself. Thus, if your economic losses (not counting your salary) is $10,000, but you need to pay yourself a "reasonable" salary of $10,000, then your tax loss will be at least $20,765 ($10,000 economic loss + $10,000 salary + $765 in employer-paid payroll taxes). In an S-Corp, your tax losses will always be greater than your economic losses, and your tax profits will always be less than your economic profits.

What's an Unreasonable salary?

Zero salary is unreasonable. No one works for free.

Salary below minimum wage is unreasonable. You would not persuade a non-shareholder to accept a job offering below minimum wage.

Salary far in excess of an appropriate wage is unreasonable. Paying a million-dollar salary when an officer in similar position would expect to make only $150,000 is also unreasonable. Some S-Corporations have attempted to pay higher-than-normal salaries as a way to increase business expenses.



Why is Officer Compensation an Audit Priority?

The IRS can collect payroll taxes on officer compensation, and please beware that the penalty for failing to pay payroll taxes is 100% of the taxes owed.

You will be liable for social security and Medicare taxes and withheld income tax if you do not deduct and withhold them because you treat an employee as a nonemployee, including yourself if you are a corporate officer, and you may be liable for a trust fund recovery penalty.

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