

Ideas for Your Success

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Classification conundrum

S corporations must be careful with payments to shareholder-employees

To avoid becoming an IRS audit target, S corporations must pay close attention to how they classify payments to S corporation shareholders. What raises IRS ire is S corporations that make distributions of profits in lieu of paying “reasonable” salaries to employee-shareholders. Why? Because these companies can realize significant employment tax savings.

If an S corporation is caught misclassifying payments, it likely will be audited, possibly resulting in a bill for the unpaid employment taxes, plus penalties and interest.

Payment classification

S corporations have been a highly popular entity choice for businesses, and their number has continued to grow since Congress relaxed its requirements for electing S status in 2004.

In many ways, S corporations offer private business owners the best of both worlds. Like C corporations, S corporations provide limited liability and an unlimited corporate life span. And similar to partnerships and proprietorships, S corporations are flow-through entities for federal income tax purposes. This means that income is taxed only once — at the individual shareholder level.

When paying shareholder-employees, S corporations may classify outflows as either salary expense or shareholder distributions.

Classifying payments as salary expense lowers the business’s taxable income, which, in turn, reduces the amount of taxable income that flows through to individual shareholders. But salary payments are subject to payroll tax.

Classifying payments as distributions, on the other hand, doesn’t reduce the business’s taxable income. But most distributions are payroll-tax free.



There isn’t a dollar-for-dollar tradeoff between classifying shareholder-employee payments as salary expense vs. distributions. In other words, it isn’t a wash from the IRS’s perspective, because the government loses out on FICA and Federal Unemployment Tax Act (FUTA) taxes.

IRS audits seek to recoup these forgone taxes when S corporations understate reasonable salaries for shareholder-employees. The IRS looks for various red flags — see “Identify the red flags” on page 4.

Supporting documentation

The IRS offers no hard-and-fast rules for estimating reasonable compensation. But thorough documentation can help support an S corporation’s classification of shareholder-employee payments.

You can turn to executive compensation studies, trade associations and executive headhunters for data on reasonable salaries, but estimates should be customized for company- and shareholder-specific factors.

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A helping hand

Use an intrafamily loan in this time of need

The recession has ravaged many families' finances, perhaps because of unemployment, retirement fund losses or stock portfolio losses. If your adult children or other family members need assistance paying their mortgage, insurance premiums or other types of expenses, an intrafamily loan may be the answer.

But before taking action, it's important to understand the tax implications if the loan isn't properly handled.

Loan rules and regulations

An intrafamily loan requires more than a simple handshake. You must put it in writing. Have the borrower sign a promissory note that details the payment terms and interest rate. If you don't, the IRS may assume the loan is a gift, which can trigger gift taxes or reduce your lifetime gift tax exemption.

When family is involved, you may want to charge low or even no interest. But generally it's best to charge at least the "applicable federal rate." If you charge less, the IRS will treat the difference as "imputed interest," which means you'll pay income tax on that amount whether you collect it or not. What's more, forgone interest will be treated as a gift to the borrower for gift tax purposes.



There are two exceptions to the imputed interest rules. First, you can make a low- or no-interest loan of up to \$10,000 to a family member without creating tax problems, provided the borrower doesn't invest the proceeds in income-producing assets (such as securities or rental real estate). Second, imputed interest on loans up to \$100,000 is generally limited to the borrower's net investment income.

Don't let good intentions go bad

If a loved one is in financial trouble because of the recent economic downturn, you may feel fortunate that you can step forward and offer financial assistance. But don't let the IRS ruin your good intentions because you improperly structured an intrafamily loan. If you're unsure of the tax implications, consider seeking the help of your financial professional.

And the job goes to . . .

Tough competition for few construction jobs requires a perfect bid

When business is slow and competition cutthroat, what is arguably a construction company's greatest asset? Its bidding process. If your company is losing out on too many jobs, it may be time to review and refine your bidding process.

Pricing is the top consideration when putting together a bid, and yours needs to be right on. That's not easy, though, when the costs of commodities such as fuel and steel refuse to stay in one place. And it's impossible to be competitive if you don't know both your own costs and the scope of the work involved.

Everyone will have specs and drawings in advance, but even the most complete bid documents won't have all the information you require. That's why pre-bid meetings are important. Go to all of them so you can ask questions, review specifications and clarify expectations.

You should already have a good handle on your overhead costs and labor capabilities, but be on the lookout for anything in the specs that could require adjustments. If

architectural details such as offsets or unusual rooflines may slow your crews, price that portion of the work a little higher than normal.

Be sure to walk the job site, too. Look for potential problems with site access or equipment storage, as well as soil type, depth of water table and terrain.

Keep in mind that price may not be what carries the day. Before you submit the bid, ask the owner what factors, other than price, will be considered and what the deciding factor will be. For instance, if you offer to provide extra services, such as handling all permitting and approvals or coordinating job-site utilities, you may build the goodwill that puts you over the top.

Finally, know when *not* to bid. If a job doesn't capitalize on your core strengths, or is for an owner or architect that has been problematic in the past, do you really want it? It may be tempting to bid on anything that comes along, but doing so can be costly.

Taking the next step

After allocating assets, don't forget to rebalance

In finances, as in golf, follow-through is critical to success. For example, if you took the time to carefully construct your estate plan but fail to ever revisit and revise it, you'll greatly increase the chances your assets won't be distributed as you wished.

The same goes for your investment portfolio. After your initial asset allocation that perfectly balances your risk tolerance and financial goals, you'd be foolish to expect it to continually realize solid and steady returns without ongoing attention. You need to occasionally rebalance your assets to increase the chance you'll continue to realize positive returns.

Fluctuating markets, lopsided portfolio

Market fluctuations cause your investments to continually gain and lose value. Over time, financial market movements can cause significant imbalances in even the most carefully constructed asset allocation — potentially exposing you to excessive risk.

By rebalancing your existing portfolio into line with your target weightings, you can realize two benefits: 1) greater peace of mind about your portfolio's ability to withstand market volatility, and 2) the opportunity to improve your portfolio's long-term performance.

Left on its own, your portfolio likely will become lopsided, too heavily tilted toward recent strong performers. This imbalance can set you up for big losses when market trends shift — as they typically will.

The other side of the equation is that your portfolio may become underexposed to the asset classes that have been underperforming. Owning fewer of these investments means missed opportunities when they begin to return to favor.

Actions and timing

To bring your portfolio back into balance, consider selling some of the securities that have overgrown their target allocation. Then use the proceeds to buy more of the underrepresented investments.

Another option is to keep the "overgrown" securities but invest more money in your portfolio and buy more of the recent underperformers to bring them into line with your target weighting. This approach will automatically reduce the percentage of your portfolio devoted to the better-performing assets.

Because emotions can get in the way of smart investing, make the rebalancing process automatic. You're more likely to stick to it and realize its long-term benefits. Many financial advisors recommend rebalancing on a regular schedule — say, once per year or quarter.

Another common approach is to rebalance whenever your portfolio weightings vary from your target by a specified amount — say 5%. This approach requires you to monitor your portfolio relatively closely.

Beware the capital gains tax

Rebalancing involves buying and selling securities, which can expose you to capital gains tax if you're working within a taxable investment account. This is particularly true because rebalancing usually involves selling some of your best performers.

Thus, you'll need to decide whether your tax costs may outweigh the potential long-term performance benefit of rebalancing. Your financial advisor can help you compare these pros and cons.

The decision to rebalance generally is easier in a tax-advantaged retirement account such as a 401(k) or an IRA. Because transactions in these accounts don't incur capital gains tax, you can reap the benefits of rebalancing with fewer costs.

Don't let your portfolio fall out of step

It's important to remember that, with investing, there are no guarantees. Risk will always be involved, but rebalancing your portfolio with the help of your financial advisor can give you greater peace of mind that your investments won't fall out of step with your financial goals.



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For example, large, profitable firms typically can afford to pay more than smaller firms. Yet smaller firms may need to pay more to attract talent. Also, because of the economic downturn, companies generally have been cutting back on salaries. Keep in mind that education, professional training and reputation all contribute to an executive's worth. Corporate loan guarantees also demonstrate an owner's contribution to a corporation.

Finally, it's important to formally document the duties and responsibilities of all employees and compare the amounts competitors pay for similar jobs. This is a company-specific factor, because the protocol for paying employees varies.

Passing muster with the IRS

Setting reasonable compensation levels can be subjective. What's considered high for one company may be low for another because of many variables. If your company

Identify the red flags

When determining whether an S corporation has correctly classified payments to shareholder-employees, the IRS searches for a few red flags, including the absence of S corporation owners' compensation expense and an inconsistent salary and distribution history.

Companies that use a one-size-fits-all approach to classifying shareholder-employee payments also will raise a red flag. Also realize that the IRS may look at "disguised distributions," such as shareholder loans, corporate payments of personal expenses or in-kind asset distributions, when evaluating shareholder payments.

is set up as an S corporation, take extra care that your compensation levels are reasonable. If the IRS determines that you've put forth a good-faith effort, it's more likely to defer to your judgment.