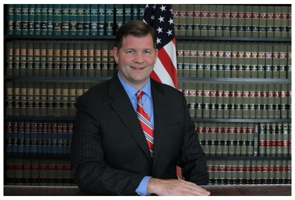

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Compensating Yourself as Business Owner

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If you work in a business you own, you may be able to increase your take-home dollars by carefully planning how you compensate yourself. If you're like most owner-employees, you want to get the most out of your company, and that often means minimizing the amount you give to taxing authorities. As an owner-employee, you pay not only income tax, but both the employer's and employee's portion of the Social Security payroll tax on your own wages, and perhaps unemployment taxes as well. Depending on how your business is organized, you may also have to pay corporate taxes.

Depending on the size and structure of your organization, you may have several options for putting together a compensation package that works for both you and your company. But before making any final decisions, be sure to review the pros and cons of each option, and speak with your accountant.

Compensating yourself with cash

It may seem convenient to simply compensate yourself with the business's cash proceeds, particularly if your business is new, small, or in a cash-based industry such as a store or restaurant. For example, might it be tempting to simply empty out the cash register at the end of each day and pocket the earnings? Or when deliveries arrive at the back door, could you pay cash on delivery and take home the difference or put it in a bank account?

While taking cash may seem the easiest and fastest way to pay yourself, there are several reasons why this is an extremely risky practice:

No way to calculate or verify income tax liability. If you merely take cash out of the business as needed and fail to properly record each transaction, you will have no accurate record of your earnings, obligations, and potentially tax-deductible expenses. If you are audited, you may have to pay overdue taxes, interest, and penalties on amounts taken as earnings but not claimed.

Example(s): *Ken owned a coin-operated laundry. Every day, he emptied the quarters out of his machines, rolled them, and took them across the street to the bank where he cashed them in for currency. He banked a portion of his earnings, paid many of his expenses with cash, and spent the rest, keeping sporadic records of how much he earned, banked, and spent. At the end of the year, he told his accountant that he earned only $40,000 from the business, although he wasn't exactly certain this figure was accurate. During an audit, the IRS examined the laundry's water bill from the previous year. Based on the number of gallons of water used, the IRS was able to determine how many wash cycles had been run at the laundry during that year. At $1.50 per cycle, the IRS determined that Ken earned approximately $70,000 after expenses. Ken had to pay tax, interest, and penalties on the additional $30,000 of income.*

Caution: *If the IRS determines that you earned more than what you actually took out of the business, then without proper records, you will have no grounds to dispute its assessment.*

No way to prove profitability of business. Someday you may want to sell your business, and in order to so, you must be able to demonstrate profitability to a potential buyer. If you have been paying yourself out of the company cash till and not keeping accurate financial records, you risk undervaluing your business — perhaps significantly.

Example(s): *Karen owned a video arcade. Every day, she emptied the quarters out of the machines, rolled them, and took them across the street to the bank where she cashed them in for currency. She banked a portion of the earnings, paid many expenses with cash, and spend the rest, keeping very little record of any transactions. At the end of the year, she told her accountant she earned only $40,000 from the business, when in fact she earned about $70,000. Shortly thereafter, Karen wanted to sell the arcade and retire. She told the buyer that the arcade earned $70,000 annually in previous years. The buyer asked to see earnings records. The only records Karen had were tax returns, which showed annual earnings of only $40,000. Karen was unable to verify the business's true worth, and therefore had to accept a purchase price that was much lower than its actual value.*

No way to demonstrate earnings to a potential lender. Should you approach a bank or another potential lender to apply for a loan, you will need detailed and accurate financial records showing your revenues and cash flow. Any potential lender will want to verify that you can afford the loan payments.

Potential loss of corporate limited liability. If you own a C corporation, chances are you chose that form of business entity to gain limited personal liability. The reason that owners of C corporations enjoy limited liability is because the corporation is deemed a separate legal entity. However, status as a separate legal entity can be revoked by a judge if the business owner ceases to treat the corporation as a separate legal entity. If an owner regularly transfers money in and/or out of corporate accounts for his or her own use without a sound business purpose, and without documenting the transfers as wages or distributions, then it could be determined that the owner is treating the corporation as his or her own personal piggy bank. A court can rule that the corporation no longer exists as a separate legal entity. At that point, the owner is personally liable for any claims brought against the corporation.

Compensating yourself with wages and dividends

If you own a corporation, you should consider whether it might be more advantageous to receive wages or dividends. (Unless you own a corporation, it makes little difference.) Your primary consideration will be your personal cash-flow needs and the company's cash-flow needs. As a corporate owner, your decision could affect how much money you potentially net from the corporation in a given year.

Wages. If you own a company and are also employed by that company, then you likely pay yourself at least some wages. Wages are your regular periodic compensation for work performed as an employee. They are a tax-deductible business expense, paid out of company revenues, and paid whether the company is profitable or not (although some owners may waive their wages to help the company through a cash-flow crisis).

Dividends. Dividends are another form of payment, a periodic distribution of the company's earnings. Unlike wages, dividends are not deductible as a business expense. They are your share of the company's profits — the return for your investment in the company. Typically, dividends are paid when the company makes a profit during a given business period and profits are distributed to shareholders.

What if you own a C corporation?

If you own a C corporation, this may influence the compensation decision substantially. That's because you may take home more money and pay less to the taxing authorities if you receive more of your compensation in the form of wages and less in the form of dividends. That's because a C corporation is subject to so-called "double taxation." This means corporate earnings are taxed first as income to the corporation; later, when corporate profits are paid out to shareholders in the form of dividends, they are taxed again. In contrast, wages are a deductible expense to the corporation and taxed as income only to the recipient.

Example(s): *Assume that shareholder A is in the 35% individual tax bracket and is the sole shareholder of XYZ corporation. XYZ is a C corporation in the 34% corporate tax bracket. As a C corporation (not a pass-through entity) with $100,000 in profits and assuming no deductions, XYZ's corporate tax would be $34,000 (34% of $100,000). The remaining $66,000, if distributed to shareholder A as a dividend, will be taxed again at 15%: 0.15 x $66,000 = $9,900 in taxes. When combined, the tax rate for the corporation and the shareholder would equal 43.9% for a total of $43,900 in taxes. Note that this is an oversimplified example for illustrative purposes.*

Caution: *Wages are subject to Social Security taxes and unemployment taxes that are additional expenses to the corporation. Dividends, on the other hand, are free of these taxes.*

Caution: *As a result of tax law changes, the advantage of wages over dividends may be lessened. In fact, because wages are subject to payroll taxes and dividends are not, dividends may be more advantageous than wages if your business does not need the wage deductions to offset corporate income taxes.*

What if you own an S corporation?

Unlike a C corporation, an S corporation is a pass-through entity for tax purposes and is not subject to so-called double taxation. All earnings and profits of an S corporation are taxed to the shareholders. Earnings and profits are reported as income to the shareholders on Schedule K-1. Accordingly, regardless of whether you take your income out of an S corporation in the form of weekly wages or in the form of K-1 income, you will pay federal and state income taxes on what you receive.

Example(s): *Continuing with the example above, if instead XYZ were an S corporation (a pass-through entity), only the shareholder would be taxed. Shareholder A would pay $35,000 (35% of $100,000) in income tax. Total taxes paid on the $100,000 would be $8,900 less than it would be in the scenario above.*

Be careful not to pay yourself unreasonably high wages

If you pay yourself unreasonably high wages, then the plan can backfire. Pay yourself well for the services you perform, but don't pay yourself unreasonably well. Unreasonably high salaries may be recharacterized as constructive dividends by the IRS. If the IRS determines that you are receiving dividend distributions disguised as wages, then that compensation will be taxed as a dividend and you will be liable for interest and penalties as well.

Few issues are more frequently addressed by the tax court than the corporate deduction for wages paid to employee-shareholders, especially in closely held corporations. There are no specific dollar amounts that courts can use as guidelines to determine the actual value of services. Therefore, determinations are made on a case-by-case basis, considering facts and circumstances unique to the situation and relying heavily on the intent of the parties involved.

The following are questions used by courts to determine whether compensation paid to shareholders is reasonable:

- Would an unrelated outside investor consider the compensation reasonable?
- How does the amount of compensation compare with the amount of dividends paid?
- How does the compensation compare with the profit performance of the corporation?
- Was the level of compensation arranged in advance, or was it based on corporate profit?
- What is the typical level of compensation in the corporation's industry?

A compensation package would likely withstand scrutiny by the IRS if it approximates the amount that would be paid in an arm's-length transaction.

What about golden parachute payments?

The IRS defines a parachute payment as compensation that is contingent on the change of ownership or control of a corporation and paid to certain officers, shareholders, or highly compensated individuals. The part of the payment that exceeds three times the recipient's base amount is not deductible as compensation by the corporation. In addition, the recipient is assessed a 20% tax on the excess amount.

Tip: *The base amount is average annualized compensation payable for the five years prior to the change in ownership or control.*

Caution: *An arrangement involving a potential parachute payment should be carefully planned to avoid triggering IRS sanctions.*

Other forms of compensation

In addition to the traditional forms of compensation discussed in the preceding sections, business owners can use other strategies for generating income while managing taxes.

1. Renting or leasing property to your business

Leasing property to your C corporation is an effective way to withdraw money from the corporation without incurring additional payroll taxes. A corporation can pay rent to a shareholder for use of the shareholder's property. The corporation takes a tax deduction for rent paid, and the shareholder reports rental income on his or her personal return. Distributions in the form of rent will not only help avoid the double tax on dividend distributions from a C corporation, but can also help avoid payroll taxes on wage payments.

Example(s): *Assume Hal owns a C corporation. The corporation earmarks $100,000 of revenues for distributions to Hal as dividends. Before the company can make a distribution, it must pay corporate income tax at a rate of 25%. That leaves $75,000 available for distribution to Hal as dividends. When Hal receives the money, he is taxed at a capital gains rate of 15%. Out of the original $100,000 of revenues, Hal takes home $63,750.*

Example(s): *Assume Dick also owns a C corporation. He rents a building to his company, and the company earmarks $100,000 of revenues for annual rental payments. The company is allowed to take a deduction for the rental payments (assuming that they represent a market value rental payment). Accordingly, the entire $100,000 is paid out to Dick as landlord. When Dick receives the money, he is taxed at an ordinary income tax rate of 35%. Out of the original $100,000 of revenues, Dick takes home $65,000, $1,250 more than Hal.*

You can rent property to your business when you own real estate or personal property that your business can use. If you own a C corporation and want to take advantage of certain tax benefits, then the transaction should be treated as an arm's-length transaction and should have a valid business purpose.

Tip: *You can gift property directly, or by way of a trust, to your children, spouse, or other family members. In turn, they can lease the property to your company. If they are in a lower tax bracket than you are, they will be taxed at a lower rate on the rental income they receive. This may lower your family's combined tax liability.*

Caution: *Under the kiddie tax rules, for children under age 18, or children under age 19 (or full-time students under age 24) who don't earn more than one-half of their financial support, any unearned income over $2,100 (in 2017 and 2018) is taxed at the parents' marginal tax rate.*

Caution: *As with the other distribution methods, the IRS will reclassify the rent as a dividend when payments are unreasonable.*

Caution: *If your company is not a C corporation, then there is no issue regarding double taxation of dividend distributions. You can still lease property to your company, but you will not receive the tax benefits available to owners of C corporations.*

Tip: *It is usually advisable to have an independent appraiser set the rental rate. It doesn't guarantee that the IRS won't scrutinize the transaction, but it gives the company a basis on which to sustain its rental deductions.*

Note that if you rent a portion of your home to your business, you may not claim a deduction for home expenses that are attributable to the rental of the residence to the business during any period of time in which you use the residence as an employee of the business.

Also, income received from the rental of personal property (such as vehicles or equipment) is subject to self-employment tax if the activity is conducted as a business. The IRS examines a number of factors when determining whether rental activity constitutes a trade or business, including the following:

- The taxpayer's profit motive
- The amount of time devoted by the taxpayer to the activity
- Whether the activity is conducted on a regular, ongoing basis

2. Lending money to your business

Another way to get additional compensation from your business is to earn interest income by lending money to it. Although an owner will often infuse cash into a company to fund operations and/or growth, an alternative is to loan money to the company. The loan will provide the company with a lump sum of cash, and the company can repay the loan over time, with interest. Those interest payments may be a tax-deductible expense to the company and will only be taxed as income to you. The interest payments provide you with an income stream in addition to your salary and regular distributions.

Caution: *Provided you don't charge an unreasonable rate, the interest you earn will not be considered wages or dividends for tax purposes. However, if the IRS determines that your interest rate is unreasonably high, it may deem your interest income from the loan as additional wages or dividends that may result in additional taxes, interest, and penalties. Also, other factors are considered when meeting IRS guidelines for shareholder advances to a corporation. You should carefully document your loan transaction (and include a promissory note) to avoid any mischaracterization of your loan transaction. Consult a tax or legal advisor if you lend money to your business.*

Tip: *If you own a C corporation, you can avoid double taxation by shifting dividend income to interest income. This can be done by loaning money to your company. The company will pay interest on the loan, but that interest is a deductible expense to the corporation. It will only be taxed once, as income to you. Your company will have less money to pay you in the form of dividends, but you will have already collected the money in the form of interest payments.*

Another potential benefit of lending money to your business is that you can leave company assets unencumbered. Often when a company borrows money from a bank, it must post its assets (and sometimes its owner's assets) as collateral. When you loan money to your own company, you can loan it on an unsecured basis if you like. (If you are the sole shareholder, the company's assets belong to you anyway.) This leaves the assets unencumbered and available to use as collateral in other transactions.

Caution: *If you post assets as collateral in a subsequent loan transaction, then the lender may acquire rights in the property that are superior to your own.*

3. Borrowing money from your business

Yet another way to get additional benefits from your business is to borrow money from it. You will have to pay the money back, but you will be borrowing from a friendly creditor. The ability to borrow from such a source has many economic benefits. Banks and other lending institutions often require collateral, charge high interest rates, require applications, and tend to be inflexible with regard to terms. Much of this can be avoided if you borrow from your own company.

You might choose to borrow for the following:

- Mortgage or bridge loans to help with the purchase of a home
- College or private school tuition for children
- Meeting extraordinary medical needs, tax bills, or other personal or family emergencies, such as divorce settlement costs
- Purchase of life insurance
- Purchase of a car, vacation home, or other expensive item

Tip: *If the loan is less than $10,000, you may be able to borrow interest free. For most loans above $10,000, the rates can be favorable, provided they are not unreasonably low. If the rates are below the applicable federal rate set monthly by the IRS, they will be imputed under a series of IRS rules.*

Caution: *Whether or not a loan from your company is secured or unsecured is one of several factors the IRS will examine when determining whether or not your loan is, in fact, a distribution.*

Tip: *Loans to corporate executives do not fall within the definition of welfare benefit plans or pension plans for Employee Retirement Income Security Act (ERISA) purposes. Therefore, ERISA requirements don't apply.*

The tax rules surrounding borrowing from your business are complicated and can be confusing. This increases the administrative costs of managing the loan. Troubles arise if you fail to properly document the loan or fail to structure a loan that is reasonable, based on current market conditions. You will need a promissory note signed by you and the company. The note should include details regarding the amount loaned, the term, and the interest rate. If the loan is under $10,000, the interest rate may be zero, but not if the principal purpose of the loan is to avoid federal taxes.

When determining whether or not a loan should be deemed a dividend distribution for tax purposes, the IRS and courts will consider the following factors:

- Whether the loan agreement places a cap on amounts advanced
- Whether security was granted for the loan
- Whether the shareholder was in a position to repay the loan
- Whether a repayment schedule was established and/or maintained
- Whether a maturity date was set
- Whether interest was charged
- The loan amount
- The extent to which the shareholder controls the corporation
- The earnings and dividends history of the corporation
- Whether a promissory note was executed

Note that interest you pay on the loan is deemed income to the company and will be taxed as such.

3. Benefit programs

You can get more out of your business by taking advantage of fringe benefits and employee benefit plans. As an employee in your own company, you can participate in any employee benefit plan that your company offers. You can also take advantage of tax-advantaged executive fringe-benefit programs, including company cars.

Employee benefit programs

You can participate in any of the employee benefit plans that your company offers to its employees as a group. Participation in such plans, including employee fringe-benefit plans, can provide you with vision care insurance, dental insurance, adoption assistance, disability insurance, or legal services, to name a few.

Some employee benefit plans, such as certain group life insurance plans, fall under the heading of welfare benefit plans. These plans are subject to ERISA and, as such, are not permitted to discriminate in favor of executives or other highly compensated employees. In other words, if your company offers the plan to you and other highly paid executives, it must also offer the plan to all of your employees. As long as every employee has the same opportunities and advantages under the plan, you are free to benefit as well.

Caution: *If you are the owner of more than 2% of the stock of an S corporation, you cannot exclude certain fringe benefits from income.*

Participating in tax-favored executive fringe-benefit programs

There are a number of tax-favored fringe-benefit programs that your company may offer to you and other highly paid company employees. These include the following:

- Business-related working-condition fringe benefits
- Convenience-related meals and lodging
- De minimis fringe benefits
- Insured health-plan coverage
- Athletic facilities
- Qualified parking
- Qualified bicycle commuting

Because a corporation is permitted to offer these programs on a selective basis, you can take advantage of them without offering them to all employees.

Expenses paid by the company

Some expenses, such as club dues, may not be a deductible business expense for your company. However, if the company pays the expenses directly (rather than in the form of a reimbursement), you may be able to receive the benefit as a qualifying working-condition fringe benefit. Your company will not be able to deduct the expense, but you will not have to claim the value of the benefit as income. However, if your corporation pays for your personal expenses, these payments will be treated as deemed dividends.

Company cars

To the extent a company car is used for business purposes, you can exclude this fringe benefit from income as a working-condition fringe benefit. However, unreimbursed personal use of a company car (which includes commuting) is treated as a taxable fringe benefit to you and is reported on your Form W-2.

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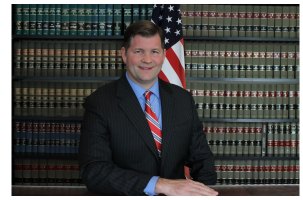

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