Compensation Strategies: C Corporations

Deciding how much to pay yourself when you’re the one handing out the paychecks can be difficult. You want to make sure that you pay yourself a salary that supports your lifestyle, but you also want to make sure that your business doesn’t suffer as a result. Based on the type of business entity you own, you may have to abide by certain governmental regulations that will affect how you pay yourself and how you pay income tax. C corporations are considered their own entity, completely separate from the business owner, for tax purposes. So, as an owner and shareholder of a C corporation, you will have to decide how to pay yourself in a way that minimizes double taxation while still qualifying as “reasonable compensation.”

When determining how to pay yourself as the owner of a C corporation, consider the following:

- **The C corporation balancing act**
- **Reasonable compensation**
- **Determining reasonable compensation**
- **Avoiding penalties**
- **Benefits of C corporations**

**The C corporation balancing act**

Paying yourself as an owner of a C corporation is a balancing act of minimizing taxes while maximizing compensation. While determining how to do this, you will also have to keep in mind how best to avoid IRS penalties or investigations. As a C corporation owner, you receive a salary just like any other employee in the company. And, since C corporations are considered an entity separate from the owner for tax purposes, this salary is deductible and requires you to pay income tax at your individual rate. But salaries aren’t the only thing taxed in a C corporation. Any profits left in the business after salaries are paid out will be taxed once at the corporate level and then again at the shareholders’ level when distributed as dividends. If you own a C corporation, you’ll be double taxed on profits you earn in dividends—once when your company earns them, and again when you receive them as distributions. Since employee salaries (including your own) are not double taxed, business owners will want to maximize salaries (which are only subject to personal income tax) and minimize distributions (which are taxed at both the corporate and individual level). It might seem simple—you can simply set your salary high enough...
so that there are no additional profits, and avoid taxation on distributions altogether. However, the IRS watches C corporations closely for this and can accuse you of unreasonable compensation if you use this method.

**Reasonable compensation**

If the IRS determines that an owner of a C corporation has a potentially inflated salary, it will likely launch an investigation, which could result in a notice of tax deficiency. This gives the IRS the power to reverse the portion of salary deduction it deems excessive and impose additional taxes and penalties. It’s important to make sure you are within the IRS limits of “reasonable compensation” to avoid paying excess taxes or penalties, which can be higher than the taxes you were trying to avoid in the first place.

The only problem is that the IRS does not provide a definition for “reasonable compensation.” It deems excess compensation excess because it is not an “ordinary and necessary” expense of the business, yet it also does not specifically define “ordinary and necessary.” This can be frustrating for business owners, but there are some methods to determine reasonable compensation on your own.

**Determining reasonable compensation**

As with any job, salaries will differ greatly from industry to industry and even within industries based on the size, location and profitability of the company. One way to determine your salary is by maintaining income as a percentage of company profits. For a smaller company with relatively small profits, the percentage may be higher than for a larger corporation. Most companies arrive at a fair pay rate based on survey data showing the competitive rate of people in similar jobs in similar industries, size groups and locations. There are other ways to determine reasonable compensation as well. The IRS lists the following factors to help determine whether pay is reasonable:

- Duties performed by employee
- Volume of business handled
- Character and amount of responsibility
- Complexities of the business
- Amount of time required
- Cost of living in the locality
- Ability and achievements of employee
- Pay compared with gross and net income of the business, as well as with distributions to shareholders
- Policy regarding pay for all employees
- History of pay for each employee

In addition, you can look at methods that have provided favorable court rulings in the past. Performance-based compensation, including compensation based on number of hours worked, number of roles fulfilled and value created for the company, is viewed favorably by the IRS. Case law exists specifically to support the argument that those who perform multiple roles within a company (a CEO who started the company, developed the product, has the most lucrative sales, etc.) should be awarded higher compensation. This is known as the “multiple hats” theory.

It helps to have data and written evidence to support your compensation. For example, Economic Resource Inc. (ERI) provides compensation data that the IRS often relies on to determine whether officers’ compensation is comparable to others in similar industries. Officers can also have independent compensation companies set their salaries based on predetermined formulas correlated to performance—this shows third-party impartiality and can help you justify your wages. It also helps to put compensation in writing before it is paid out, preferably at the beginning of the year, before company performance is known. Other documentation can be in the form of minutes of a corporation’s board of directors, which can show an increase in your participation in the company, which can directly relate to an increase in salary.

**Avoiding penalties**

You should try to avoid the following to avoid IRS suspicion:

- Large bonuses and/or compensation paid out at the end of the year (after profits are determined)
- Paying compensation in direct proportion to stock owned (can be seen as paying out dividends in disguise)
- Paying no dividends to shareholders—this is a red flag to the IRS that the corporation is trying to pay out all of its profits as compensation

**Benefits of C corporations**

Although there are possible penalties to keep in mind with C corporations, this type of business entity can also provide benefits for owners, including:

- Corporations can deduct 100 percent of the health insurance paid for employees, including employees who are shareholders. They can also deduct the costs of a medical reimbursement plan. That means that if you are a shareholder with above average medical expenses, you
can establish a plan for yourself that results in most or all of your expenses being deductible.

- C corporations have the power to deduct fringe benefits, such as group term life insurance, employer-provided vehicles, education costs, etc.
- Not all aspects of taxes associated with C corporations are negative—since corporations are taxed as a separate entity, they are subject to a lower tax rate than individuals.