Misunderstandings About Salary vs. Dividends May Lead To More Small Business Audits

By Joseph M. Donegan on September 26th, 2012 Posted in Business Tax, IRS, Taxes

Business owners whose companies are structured as S-Corporations earn several tax benefits from this label. Most notable of these benefits is that businesses are classified by the Internal Revenue Service as a flow-through entity, in which corporate income, losses, and deductions are reported on individual tax returns and assessed at individual income tax rates.

While this allows S-Corporations to avoid double taxation on corporate income, the structure may also leave more small companies open to scrutiny from the IRS if they fail to understand or abide by federal tax law relating to dividends and salaries. Owners who work for their company in an employment capacity have the option of taking profits from the business and allocating them in two ways.

The first is compensation in the form of a salary or wages, which is subject to regular payroll taxes. The second is distributions – or dividends – which are not subject to payroll tax and are taxed below the ordinary income rate.

Issues may arise if the IRS feels that small business owners may set artificially low wages to avoid paying as much as they should in payroll and income taxes. Further, the IRS stipulation that shareholders pay themselves “reasonable compensation” based on market rates for similar jobs in the area can leave some salary assignments open to interpretation by owners, which may complicate the scenario further.

Business owners who take advantage of both wages and distributions should consider conducting research into the standard salary offerings of similar positions to avoid the scrutiny of the IRS. In an era where small businesses are receiving the majority of federal audits, it may pay to be more cautious about business practices that involve taxation issues.