Business owners want to compensate themselves and their top executives fairly and competitively for their work, results, and commitment. So, how do you achieve that goal without attracting undue IRS scrutiny and claims of inappropriate compensation? By making informed, astute decisions.

Start with the Basics

Compensation is affected by the amount of cash in your company's bank account. Just because your financial statements report a profit doesn't necessarily mean you'll have cash available to pay owners a salary or make annual distributions. Net income and cash on hand aren't synonymous.

Other business objectives — for example, buying new equipment, repaying debt, and sprucing up your offices or facilities — will demand dollars as well. So, it's a balancing act between owners' compensation and dividends or distributions on the one hand, and capital expenditures, expansion plans and financing goals on the other.

C Corporation Challenges

If you operate as a C corporation, your business is generally taxed twice. First, its income is taxed at the corporate level, and then it's taxed again at the personal level as the owners draw dividends. This is a long-running challenge to those who own C corporations.

In light of the situation, many owners have been tempted to classify all the money they take out as salaries or bonuses to avoid being double-taxed on dividends. But the IRS is wise to this strategy: It's on the lookout for excessive compensation to owners and will reclassify above-market compensation as dividends, potentially resulting in additional income tax as well as interest and penalties.

The IRS also monitors a C corporation's accumulated earnings. Much like retained earnings on your balance sheet, accumulated earnings measure the buildup of undistributed earnings. If these earnings get too high and can't be justified as needed for things such as a planned expansion, the IRS will assess a tax on them.

Know Your Flow-Through

Perhaps your business is structured as an S corporation, limited liability company or partnership. These are all examples of "flow-through" entities that aren't taxed at the entity level. Instead, income *flows through* to the owners' personal tax returns, where it's taxed at the individual level.

Dividends (typically called "distributions" for flow-through entities) are tax-free to the extent that an owner has tax basis in the business. Simply put, basis is a function of capital contributions, net income and owners' distributions.

So, the IRS has the opposite concern with flow-through entities: Agents are watchful of dealer-owners who *under*pay themselves to avoid payroll taxes on owners' compensation. If the IRS finds you're downplaying compensation in favor of payroll-tax-free distributions, it'll reclassify some of your distributions as salaries. In turn, while your income taxes won't change, you'll owe more in payroll taxes than planned — plus, potentially,

interest and penalties.

Beware of Eyebrow-Raisers

Above- or below-market compensation raises a red flag with the IRS, and that's always undesirable. Not only will the agency evaluate your compensation expense — possibly imposing extra taxes, penalties and interest — but a zealous IRS agent might turn up other challenges in your records, such as nonsalary compensation or benefits.

What's more, it might cause a domino effect, drawing attention in the states where you do business. Many state and local governments face budget shortages and are hot on the trail of the owners' compensation issue; they'll follow federal audits to assess additional taxes when possible.

Follow the Regulations

When setting executive compensation, you want to be aware of all current IRS regulations and other applicable requirements. We can explain in detail how federal and state laws will affect your compensation decisions.