# Exercising Corporate Due Diligence

## Proper due diligence ensures the benefits of the business structure will be upheld if challenged from a legal or tax standpoint.

Electing to be taxed under a corporate structure requires certain formalities. As the old adage goes, if you are going to call it a duck, it had better, look, walk, and quack like a duck. The same goes for your business. Organizing and maintaining your business under a corporate structure requires the owners to exercise proper due diligence in order to ensure that the benefits of the structure will be realized and upheld if challenged from a legal or tax standpoint. In addition to filing the proper corporate documents at the onset to establish a legal structure, there are several ongoing responsibilities that must be done on a recurring basis. The following is a summary of some important areas where corporate due diligence must be maintained. In particular, this discussion will focus on S Corporations, although some of the items are also relevant to C Corporations and Partnerships.

# Sufficiency of Shareholder Compensation

A shareholder's proportionate share of income from an S Corporation is not subject to self-employment tax, which often leads to abuse as it relates to compensation. There have been numerous court cases regarding shareholders taking unreasonably low or no compensation to avoid social security taxes while taking excessive distributions from the S Corporation. The IRS and courts have made it increasingly clear that distributions to an actively employed S Corporation shareholder can be recharacterized as wages subject to payroll taxes if it is determined that the distributions are actually disguised compensation. In previous years, the IRS focused their enforcement efforts on entities that paid no compensation to its shareholders. Although still a red flag for IRS scrutiny, the IRS has now changed its focus to the reasonableness of the wages that are being paid to shareholders. Unfortunately, the IRS has not issued any guidance to assist taxpayers in determining what is considered reasonable compensation. However, there are some basic concepts that should be taken into account when a shareholder is determining the amount of his or her compensation.

## Officer compensation should be paid in accordance with job duties and responsibilities.

As previously mentioned, there are no guidelines for measuring the reasonableness of compensation. The tax regulations only state that reasonable compensation is an amount paid for "like service by like enterprise under like circumstances." As a recommendation, the following factors should be considered when determining shareholder compensation:

- Level of experience and education
- Level of involvement in the business (position and hours worked)
- Industry compensation rate
- Size and complexity of the business
- The compensation paid to the highest non-shareholder/employee
- The overall success and profit-level of the business

### Profits generated by employees other than the shareholder(s) and from capital investment should not be considered wages to the shareholder(s).

Profits generated in a business that has other non-shareholder employees (other than administrative staff) are generally not based on the sole efforts of the shareholder. However, if a business is of a service nature with minimal investment in equipment and inventory, it may be difficult to argue a lower level of compensation. If, on the other hand, the business is capital intensive, there may be reasonable justification for paying a lower level of compensation.

## Shareholders are entitled to a reasonable rate of return on their investment.

View your business as you would any other investment. As a business owner, shareholders are entitled to a reasonable return on the capital they invest in a business, which should not to be considered wages to shareholder. After all, if you could do the same work for somebody else as a regular employee and make the same amount of money, why would you take the risk of investing in your own business? Calculate the return on investment by dividing the net income by the equity of the business and compare this to industry standards for similar businesses. A lower rate of return than expected may be indicative of the face that shareholder compensation is too high. Conversely, a higher than expected return on investment may indicate that shareholder compensation is being set at an unusually low level in order to avoid payroll taxes.

# Substantiation of Related Party Leases and Loans

Hand-in-hand with determining the sufficiency of shareholder compensation is the need to substantiate other types of transactions between the S Corporation and the shareholder. Besides distributions, the IRS can also deem loan and lease payments to shareholders as disguised compensation and reclassify them as wages if they are not properly documented. Therefore, these agreements need to be properly documented and based on reasonable terms. Reasonableness is based on the concept of what would be negotiated between the S Corporation and an unrelated party.

## Document Corporate Due Diligence

Keeping corporate minutes is not only a requirement but also an excellent way to document your due diligence. There is no required structure for documentation of minutes, but the following are some recommendations:

- Document minutes on a recurring basis and at least annually.
- The minutes should include a heading with the company name, time and date of the meeting, location, attendees, and officers that are absent.
- Election of officers and board members should be documented as outlined in any bylaws or organizational documents.
- Document significant activities that occurred during the period, including:
  - Approval of prior meeting minutes
  - Approval of tax return filings
  - Financial performance during the period
  - Major contracts and agreements
  - Major asset acquisitions and related financing
  - New bank accounts and the individuals with signing authority
  - Employee hires and compensation increases
  - Documentation of your consideration of shareholder compensation and director's fees
  - Approval of any related party loans and leases
  - Approval of distributions to shareholders during the period
  - Approval of actions taken by officers during the prior annual operating period

Maintaining your corporate due diligence may seem like a daunting process, but it doesn't have to be. You don't need to have a legal vocabulary or knowledge of the tax code for this process. Keep things simple and stick to the facts. Keep the language professional and straightforward. Also taking some extra time up front to establish templates for these items can save you significant amounts of time in the future. By developing some basic formats, you will be more likely to establish an ongoing process. The investment of your time in practicing corporate due diligence can pay major dividends in the event of legal litigation or audit from federal and state taxing authorities. Hopefully you will never have to experience either of these with your business, but it never hurts to be prepared.