How much should you be paid?

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Among the tough decisions dealer-owners face at year end are how much money they should take out of the business and how they should split that amount between salaries, bonuses and dividends. Although owners' compensation is somewhat discretionary, it needs to withstand IRS scrutiny.

Competing business objectives

Let's start with the basics. Your compensation is affected by the amount of cash in your dealership's bank account. But just because your financial statements report a profit, it 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 - such as buying new equipment, repaying debt and sprucing up your showroom - vie for your kitty. So, it's a balancing act between owners' compensation and dividends on the one hand and capital expenditures, expansion plans and financing goals on the other.

C corporation issues

If you operate as a C corporation, your dealership is taxed twice. First, business income is taxed at the corporate level. Then it's taxed again at the personal level as you draw dividends - an obvious disadvantage to those owning a C corporation.

C corporation owners might be 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.

In addition to the annual owners' compensation expense, the IRS monitors a C corporation's accumulated earnings. Similar generally to 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 such things as a planned expansion, the IRS will assess a tax on them.
Flow-through entity issues

S corporations, limited liability companies and partnerships are examples of flow-through entities, which 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 underpay themselves to avoid payroll taxes on owners' compensation. If the IRS thinks you're downplaying compensation in favor of payroll-tax-free distributions, it will reclassify some of your distributions as salaries. In turn, while income taxes won't change, you'll owe more in payroll taxes than you planned - plus potentially interest and penalties.

A tangled web

Above- or below-market compensation raises a red flag to the IRS, and that's definitely undesirable. Not only will the agency evaluate your compensation expense - potentially imposing extra taxes, penalties and interest - but a zealous IRS agent might turn up other challenges to your records.

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.

Professional guidance

There's more that goes into deciding your take-home pay than whim and the availability of cash. Your CPA can review factors to consider when taking cash out of the business and classifying it between salaries and dividends. He or she also can provide objective sources of compensation data to support your deductions and deal directly with IRS inquiries at his or her office, keeping IRS agents off dealership premises.

Others who care

Other parties have a vested interest in how much you're getting paid. Lenders, franchisors and minority shareholders might think you're impairing future growth by paying yourself too much. If a lender, dealer operations manager or silent partner, for example, decides your showroom looks shabby and sees flat sales, your salary expense and dividends might become the subject of debate.

If you or your dealership is involved in a lawsuit, the courts also might impute reasonable (or replacement) compensation expense. This is common in divorces and minority shareholder disputes. The amount the court prescribes for your compensation affects business value, which, in turn, affects damages awards and asset distributions. In divorce, reasonable compensation also affects child support and alimony awards.
When the court imputes reasonable compensation, it typically considers compensation studies and other factors, including your salary history, responsibilities, experience, geographic location and dealership's performance.

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