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Lookout: IRS is challenging S Corporation compensation.

There is an increased IRS audit risk for S Corporation shareholders. The service is increasing audits to determine reasonable compensation to shareholder / officers. If a controlling shareholder receives little or no compensation for services rendered to the corporation and instead receives distributions, the IRS may recharacterize a portion or all of the distributions as compensation for services per IRS Revenue Ruling 74-44. There also is an audit risk of shareholder loans recharacterized as compensation.

The amounts recharacterized as reasonable compensation are subject to employment taxes which amount to 15.3% of the compensation. The IRS audit guidelines are somewhat vague and based on economic realities. Since there are no specific guidelines for reasonable compensation in the IRS code or regulation, the courts have ruled on the facts and circumstances of each case.

Some experts believe that the IRS is following the rule known as the outside investor return guideline. The audit guideline presumes that an outside investor expects between 10% and 20% investment return per year for a privately held investment since privately held small and medium-sized businesses are high risk investments. The audit examination may change the S Corporation to reflect income of the equivalent 10-20% return and back into the officer/ shareholder salary amount accordingly.

The court ruling factors to consider are training and experience; duties and responsibilities; time and effort devoted to the business; and dividend history to name a few.

Certain strategies as noted by the Journal of Accountancy reduce the likelihood of this type of IRS audit. Enclosed are a few common strategies:

- 1) Minimize the audit risk by reporting at least compensation equal to the FICA Social Security limit which is \$118,000 for 2015. In circumstances where there are no distributions, shareholder loans, or shareholder compensation, the risk of audit may be lower because there would no economic benefits received by the officer/ shareholder. These circumstances are rare.
- 2) Another strategy is to identify Officers. Report both officers and officer / shareholders. S Corporations with total receipts over \$500,000 are required to



- report officer compensation, percentage of stock held, and percentage of time devoted to the business.
- 3) Encourage shareholders to maintain written logs. Shareholders have the responsibility to proving how much time they spent and the services they provided. Although keeping contemporaneous logs is a challenge, it is vital in the event of an audit, because the IRS and Tax Court do not accept after-the-fact estimates.
 - 4) Provide comparability compensation data. Various salary comparison services such as payroll and staffing services provide reliable industry salary data at a nominal cost. This industry and salary information should be compared to the salaries paid to the shareholder-employees of the company. The company should be able to explain any salaries outside the range of the comparable data that is either below or above it.
 - 5) Encourage shareholders to minimize loans from the company. The IRS examines loan amount reported on Form 1120S, Schedule L, Line 7, loans to shareholders. If these loans remain unpaid, and if there are not a written promissory notes with regular interest payments, the loans may, under audit, actually be considered disguised compensation to the shareholders.

Please keep these strategies in mind to minimize an IRS audit risk to your S Corporation. Also, as a general rule, when the IRS audits corporations and individuals, the service examines a minimum of the past three years of tax returns to determine compliance. Please contact our office for more information on this issue.

Your supply chain – is it a value driver?

A Valuation issue that occasionally affect businesses positively or negatively is the management of its supply chain. The supply chain may become a significant business value driver or a danger as a company grows. Supply chain risks, in some instances, are overlooked by management. Examples include risk of naturally occurring disasters, supplier labor union disputes, and litigation risks. There are four main business value drivers with the supply chain that can stabilize and provide long term growth for the business' value:

Managing Risks, Realizing Efficiencies, Creating Sustainable Products, and Building a Culture of Responsibility.

Managing Risks include minimizing business interruption from labor or environmental problems. Our office performed for a manufacturing company several years ago; let's refer to it as Company X. After interviewing management, we learned that Company X had one main supplier of raw material to the company, and the raw material supplier had informed Company X that the supplier's union went on strike and that the supplier didn't have adequate replacement workers to continue operation for the upcoming six months. Company X management informed me that if they could not find an alternate supplier

within three months, it would have to close the business because of the impact on its business; its busy season was in full swing.

As noted in the example situation, it's very important to have flexibility with suppliers and have a thorough understanding of supplier financial conditions and possible risks to their stability in providing products or services.

Risks also involve protecting the business's reputation and brand value. By having plans to mitigate risks of business disruption, the company's brand value improves in providing quality goods or services as promised. Managing risks also improve the company's ability to raise capital, financing, and obtaining insurance to allow it to grow and scale upward. When a company's supply chain is stable and predictable, raising capital and financing attracts stakeholders such as investors or lenders, to your company by lowering their perceived risk of investing or lending to the business. Another example of a supply chain impact on capital raise is one our clients in the healthcare product industry. Part of the due diligence the bank included review of financial stability of the company's suppliers. The bank's analysis and confidence in the supply chain contributed to its loan approval.

Realizing Efficiencies can take on various forms such as reduced material costs, energy, and transportation. The most cost effective alternative energy sources to-date are energy and transportation saving solutions that are energy efficient. Other important efficiencies are labor productivity such as lean manufacturing processes and robotic automation. Strategic relationships with suppliers are also effective ways to improve efficiency. Whenever both parties, the supplier and company, can realize mutually beneficial strategy partnerships, the supply chain is more efficient and both parties realize large cost savings and profitability and which also creates higher business' value.

Creating Sustainable Products is a business driver that has catapulted Apple, Inc. to being one of the most valuable companies in the U.S. based on Capitalization Value, i.e. Share price multiplied by shares outstanding. Steve Jobs' top management team focused primarily on constant innovation to meet customer requirements along with working with business supply chain partners to create one of the most profitable technology companies in the world. Another benefit of creating sustainable products is that the business can gain increased pricing power, access to new markets and solid, stable customer loyalty. Apple is a prime example of the high customer loyalty it commands with its sustainable products within the past ten years.

Building a Culture of Responsibility is a top priority of high performing management teams. There are multiple examples of improvement in culture and its relationship to driving up business value as shown in IBM's turnaround in the 1990's, Apple and its consumer products, and Zappos which sold to Amazon several years ago for just under \$1 Billion dollars. Each of these companies focused on building responsible, innovative cultures to become companies that attract high quality talent, be highly profitable, and highly valued enterprises.

Press releases that get readers' attention.

As marketing budgets ebb and flow, many companies rely on public relations as a cost-effective way to get their messages out.

Media releases, also called 'news releases' and 'press releases', can be an effective part of your company's public relations program. Unfortunately, most media releases end up in the recycling bin and never make it out of the newsroom. There's no guarantee that your news will be published or presented, but there are some simple steps you can take to improve your chances.

Find a newsworthy story

A media release is not an advertisement. It should tell editors and journalists your news in an appealing and succinct way. Finding the right story often requires research. Start by looking for interesting and unique developments in your business.

A new location or product might seem exciting within your company, but it may not be so for your audience. If there is something unique or beneficial about your new location or product, then you might have a newsworthy angle. Think about the story from the perspective of your target audience and what will interest them. If you can't find a newsworthy story now, it's probably better to wait for the right opportunity.

Write a strong beginning

The most important elements of a media release are the headline and lead paragraph. The headline summarizes your story in a few words and the lead expands upon it with more detail.

A good headline will grab the attention of an editor and make them want to read more. If you have a new product, what makes it stand out from your other products or those of competitors? Is it more efficient, less expensive, more durable, or based on cutting-edge technology? If you are promoting an event, will there be important guests, speakers or announcements?

Wordy summaries – called 'leads' - are less likely to get read, so you should summarize your news in fewer than thirty words. Good headlines and leads address the who, what, when, where, why and how of your story.

Support your story with details and quotations

The body of your media release is where you provide facts, quotations, examples and other supporting information. Decide who will be your company spokesperson and include quotations that support your news story. It is customary to introduce your spokesperson with an indirect quote and follow with direct quotations. You can quote another person if they will add insight, but avoid quoting more than two people – this can make your media release too complicated.

If editors and journalists are on tight deadlines, they do not have time to follow up to get additional quotations from your spokesperson. Relevant quotations will improve the chances of getting your story published. When you are including quotations in your

media release, remember that it's not an advertisement. Stick to the facts and avoid hype and superlatives.

Follow the standard format

Type MEDIA RELEASE at the top of the page, followed by the date, headline, lead and body text (the story itself). Include your contact details at the bottom of the page. You should also indicate the availability of photos, and opportunities to take photos and interview your spokesperson.

Target your media

A great media release is worthless if you don't send to relevant media outlets. If you have a new product that increases safety in factories, for example, it's not fitting for your local paper. You will want to target your release to publications with readers interested in manufacturing and factory safety. If you plan to send out media releases regularly, get a hard copy or online version of a media directory that lists media outlets and contacts.

Put it together

Writing an effective media release does not have to be a big challenge. Start with a good story, and write a strong headline and lead. Then follow up with supporting material, especially pertinent quotations. Finally, do the research and target your story to media outlets that have readers and viewers who will be interested in your news.

Regular Pieces

How To Make The Most Of Your Newsletter

Be sure to read each article with the mindset 'How could this apply to our business.' Thinking of it that way will guarantee that you get value. Better yet, take notes as you read and commit to having the ideas implemented by the time the next edition arrives. Also, make copies for each team member. To really make sure something positive happens, work with your business development specialist to talk your team through the ideas and how to set a schedule for getting them implemented. We're here to help you get started.

An Important Message

While every effort has been made to provide valuable, useful information in this publication, this firm and any related suppliers or associated companies accept no responsibility or any form of liability from reliance upon or use of its contents. Any suggestions should be considered carefully within your own particular circumstances, as they are intended as general information only.

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