



Lancaster County Tax Collection Bureau

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www.lctcb.org

S Corporation Local Tax Enforcement

When the Bureau identifies a taxpayer who is an S-Corporation owner who may not have paid themselves a reasonable market level wage for their involvement in the operation and or management of the business, the Bureau has the responsibility to reallocate and assess local tax on their S-Corporation draws or profits to the extent necessary to reflect reasonable compensation to ensure our local tax laws are consistently applied across the residents of our jurisdiction.

Factors that can trigger this identification include but are not limited to; no meaningful change in wage from period to period; significantly below average wages for the position. For reference an average manager's pay in Lancaster County was \$117,000, and an average business executive's wage was \$255,000 as of the most recent [BLS Data](#) available, from May 2024.

What is "Reasonable Compensation":

Reasonable Compensation is defined by Treas. Reg. § 1.162-7(b)(3) as **the amount that would ordinarily be paid for like services by like organizations in like circumstances**, and this standard is adopted in Treas. Reg. § 53.4958-4(b)(1)(ii)(A). Thus, the concept has two prongs: Amount Test – focuses on the reasonableness of the total amount paid; and Purpose Test – examines the services for which the compensation was paid.

Federal Guidance on the topic: (issued to each S-Corporation owner on their election acceptance letter)

- You must determine the reasonable salary when a shareholder-employee of an S-Corporation provides services to the corporation.
- Payments to a shareholder employee for services provided to an S-Corporation are wages and subject to employment taxes.
- Distributions paid may be recharacterized (or income allocated in the absence of distribution amounts reported) to a shareholder as salary if the distribution was paid in lieu of reasonable compensation (IRS Revenue Ruling 74-44).
- Additional federal guidance is found on the [IRS Reasonable Compensation Job Aid](#).

- Factors to consider in assessing reasonable compensation:
 - the employee's qualifications;
 - the nature, extent, and scope of the employee's duties;
 - the employee's background and experience;
 - the employee's knowledge of the business;
 - the size and complexity of the business;
 - the time devoted by the employee to the business;
 - the economic conditions generally and locally;
 - the character and amount of responsibility of the employee;
 - whether or not the compensation is pre-determined based on activities to be performed or not determined until the end of the tax year;
 - amounts paid to the employee in prior years;
 - the salary policy of the taxpayer as to all employees;
 - the amounts paid by similar size businesses in the same area to equally qualified employees for similar services.

Local Regulation on the topic: ([LCTCB EIT Rules and Regulations Sec. 204 PP D](#))

If an individual is actively involved in conducting the business of, involved with managing, or provides services to, an entity that is taxed as a Subchapter S corporation, the individual must allocate a reasonable amount of the income he or she receives from the entity as income that is subject to Tax. If an individual who is required to make such an allocation fails to do so, the Bureau shall have the right to assess Tax against a reasonable portion of the income the individual received from the entity. Under such circumstances, the Bureau's assessment of what constitutes a reasonable portion of income will be conducted by applying relevant standards published by the United States Internal Revenue Service from time to time in the Reasonable Compensation Job Aid or any successor publication thereto, other relevant guidance from the IRS, relevant guidance from other taxing authorities or bodies, relevant court decisions, and any other source that provides relevant standards. Among other factors for assessing Tax against a reasonable portion of income received from an entity that is taxed as a Subchapter S corporation, the Bureau may consider the individual's role in the affairs of the entity, the compensation paid to other employees, and the compensation paid to employees of similar businesses. In determining whether to assess Tax against income received by an individual from an entity taxed as a Subchapter S corporation, the Bureau may ask the individual for information about how the entity is managed, what involvement the individual has in the entity's operations, and other information to help make an informed determination using the standards published by the IRS and other relevant sources.

Example Assessment:

Reasonable compensation is the fair value of the services you provide to your S-Corporation, and a requirement to review and adjust your wages at least annually for the remainder of your profits to be exempt from Local Tax.

You have reported wages of \$40,000 while taking profit distributions of \$460,000. Based on the information available regarding your business, you have not been reevaluating your wages as this amount has remained consistent for the past 13+ years, and you were previously warned about this deficiency after your 202X return. You are also listed as the current company President, Treasurer, and Secretary according to your annual filings with the PA Department of State.

Accordingly, \$215,000 of your S-Corp distributions have been recharacterized as compensation for local tax purposes to raise your wage to the average business executive wage in Lancaster County, PA of \$255,000 per the Bureau of Labor statistics most recent data available, May 2024.

If you disagree with this valuation, please complete the Business Participation Affidavit on www.lctcb.org and provide a reasonable valuation of your own for reconsideration.

Failure to pay or respond to this notice by the due date listed will result in the imposition of interest, penalties, and fees on this balance.

What we expect if the taxpayer or their representative chooses to contest the assessment:

- [Business Participation Affidavit](#) of job responsibilities and participation of the shareholder, signed by the owner/operator.
- Name, Contact Info, and Wage Support for the managing employee if the shareholder is not actively involved.
- Wage analysis/valuation consistent with the responsibilities outlined by the taxpayer on the Business Participation Affidavit.
- Explanation of how wages are set and re-evaluated by the enterprise for staff and shareholders.