Menard Tax Case Illustrates Salary Issues for Entrepreneurs

The recent tax court decision that Menard, Inc., owes the IRS $5.9 million in back taxes demonstrates that officers of C corporations who are major shareholders might have large salaries challenged by the IRS.

(PRWEB) February 2, 2005 -- A recent IRS tax court decided Menard, Inc., owes the IRS $5.9 million in back taxes because, in 1998, the home-improvement chain improperly claimed $13 million as salary for John Menard that should have been classified as a dividend payment.

"As a rule, the IRS examines what it believes could be high salaries paid to major shareholders of C corporations. Sometimes, the IRS decides large salaries are really dividends in disguise," notes Peter Hupalo, author of "How To Start And Run Your Own Corporation: S-Corporations For Small Business Owners."

While salaries are tax-deductible to corporations, dividends paid to shareholders are not tax deductible to the company. This encourages some entrepreneurs who operate C corporations to pay large salaries to themselves in an attempt to minimize taxes. The idea is to avoid the double tax on C corporation dividends.

"Entrepreneurs need to examine several things. First, is the salary reasonable for the work performed? And, is it comparable to what other businesspeople in similar titles earn? If not, the entrepreneur could be in trouble. In the Menard's case, it's not obvious to me that a $20 million salary is inappropriate to the CEO of a company with $5 billion in sales and about $400 million in profits," observes Hupalo. "There certainly are far more egregious cases of excessive CEO compensation."

The case pointed out that Menard's chief financial officer (CFO) only earned $55,700 in 1998. Thus, the disparity in pay between John Menard and other corporate officers appears to have played a major role in the decision. John Menard controls 100% of the voting stock in Menard and began the home-improvement chain in 1963. Today, Menard, Inc., operates about 200 stores in the Midwest, and John Menard is considered the richest man in Wisconsin.

"With entrepreneurs who operate S corporations, the situation is reversed. Because S corporation dividends are taxed only once, some entrepreneurs try to pay unreasonably low salaries to minimize employment taxes. While the IRS is more likely to inspect high salaries for entrepreneurs with C corporations, it's more likely to be skeptical of low salaries paid to S corporation officers. In one case, entrepreneurs are trying to minimize the double tax on C corporation dividends. In the other, they're trying to minimize employment taxes," says Hupalo.

Hupalo says the case is unique in that it explores the sometimes confusing role of corporate expenses. Tax deductible payments of $1.6 million were made to Team Menard, Inc., a company sponsoring racing cars promoting the Menard brand. While the company claimed the expenses were for marketing and therefore properly tax deductible, the tax court decided the payments weren't a true marketing expense.

"NASCAR is considered by many sponsorship experts to offer one of the highest returns on investment of all sponsorship opportunities. And, there seems to be a natural match between the customers of Menard's and those interested in car racing. So, on the face of it, it's not obvious that sponsoring auto racing wouldn't be a great marketing idea. But, tax courts examine many details and relationships in making their decisions," Hupalo said.

"How to Start and Run Your Own Corporation: S-Corporations For Small Business Owners." (http://www.hcmpublishing.com)

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