

Reasonable Compensation

The IRS sends this reminder:

An S Corporation must pay reasonable compensation (subject to employment taxes) to shareholder-employee(s) in return for the services that the employee provides to the corporation, ***before*** a non-wage distributions may be made to that shareholder-employee. This issue has been identified as an area of non-compliance and will receive greater scrutiny in the foreseeable future.

What if I do not take a reasonable wage?

The issue of “reasonable compensation” for S corporation shareholders can end up in court and several decisions have held for the IRS. When the IRS is successful in re-characterizing distributions as wages, the S corporation and employee are subject to employment taxes, as well as penalties and interest for underpayment and failing to file employment tax returns. Inadequate salary, rent, or interest could also result in reallocations by the IRS.

How much is a reasonable for a wage?

There is no rigid set of rules for measuring the reasonableness of compensation. Each situation must be resolved based on its unique facts and circumstances. Several Tax Court decisions have focused on these factors:

- a) The character and financial condition of the corporation;
- b) The role the shareholder-employee plays in the corporation, including position, hours worked and duties;
- c) The corporation’s compensation policy for all employees and the shareholder’s salary history, including the internal consistency in establishing the shareholder’s salary;
- d) How the compensation compares with similarly situated employees of other companies and
- e) Whether a hypothetical, independent investor would conclude that there is an adequate return on investment after considering the shareholder’s compensation.
- f) Salaries versus distributions and retained earnings

No single factor controls, but rather a combination of the factors must be considered. Furthermore, these factors are not all-inclusive (and may not be given equal weight). Wages should be justifiable. Documentation of why the compensation is reasonable can be placed in the corporate minutes.

*This information should be used as a guideline. Specific questions regarding this “Biz Facts” should be directed to a Business by Design, Inc. tax professional.