Determining Reasonable Compensation for S Corp Shareholders

The subject of “reasonable compensation” for S Corp shareholders has been a hot issue for many years. How much is enough? Do I even have to take a salary? Can I donate my time to the business in lieu of a salary? These are some questions raised by shareholders in trying to determine adequate compensation levels, if any at all. Shareholders and their tax advisers often have differing goals when setting these compensation levels. Shareholders want to minimize salaries and increase distributions to avoid payroll taxes, while tax advisers must interpret and follow the regulations set forth by the IRS, which does not allow a shareholder to avoid these taxes by forgoing compensation.

So what is reasonable and satisfies all parties involved? There has been little guidance for tax advisers on what to recommend to their clients. However, recent court rulings have shed some light on how the IRS determines what is considered reasonable, providing tax advisers with an analytical approach to answering this question. There are 3 groups we should give careful consideration to:

- Employee Performance
- Salary Comparisons
- Company Conditions

Tax advisers should first consider employee performance. Salary should be congruent to performance considering the skill and experience, qualifications, and time and effort. A shareholder that has reduced his role in the company may be able to justify a decrease in compensation to less than an industry standard. While a shareholder who works 35-40 hours a week with more experience and responsibility would require a much higher salary. In addition, a shareholder that only provides limited services may not require any salary.

Tax advisers can then compare shareholder salaries to those of non-shareholder employees. A shareholder should not be paid less than a subordinate employee and compensation should be set at an amount that a comparable business would pay for similar services. They should consider comparing their salary with prior years as well. If sales are increasing, a shareholder might consider receiving a raise based on a percentage of sales. There are many benchmarking sources, such as staffing companies and the Bureau of Labor Statistics that can be used to determine the reasonableness of compensation.

Company conditions are another matter to consider for an appropriate compensation level. The Risk Management Association (RMA) published financial ratios that will help determine a company’s overall profitability, and how it compares to other similar sized companies located in the same region. If the ratios indicate the S Corporation is more profitable than another similar S Corporation, yet it is paying less salary, then justification for the lower
salary would need to be proven. Otherwise, an increase to the industry standard would be necessary.

Since this is such a hot topic, changes are inevitable down the road. Recently, in 2010 the House of Representatives attempted to pass a bill that would require all undistributed income of a professional S Corporation to be subject to self-employment tax. It is possible that a similar bill will be passed in the future and the tax advantages of the S Corporations would diminish. Either way, the IRS has denoted this a hot audit issue over the next few years. In light of this, it may be appropriate to re-evaluate the current compensation being paid to shareholders.