Larson Gross
CPAs & Consultants

Determining Reasonable Compensation for S-Corp Owners

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An S-Corp is a unique business structure that offers significant tax advantages. It is similar to a C-Corp in that it provides limited liability protection to its owners but differs in how it is taxed. S-Corps do not pay corporate income tax. Instead, the company's income, losses, and deductions are passed through to the shareholders, who report them on their personal income tax returns.

One of the main advantages of an S-Corp is the opportunity to minimize self-employment taxes. Pass-through income from an S-Corp to the owner is not subject to these taxes. Thus, this structure can potentially save an S-Corp owner significant tax dollars.

However, this tax advantage brings a key requirement. S-Corp owners who provide services to their company are required by the IRS to receive "reasonable compensation" in the form of salary or wages. The IRS stipulates that an S-Corp owner who performs more than minor services for the corporation and receives, or is entitled to receive, compensation must be treated as an employee.

Employee wages are subject to payroll taxes. Therefore, an owner-employee is incentivized to minimize their wages, which are subject to payroll taxes, and maximize their pass-through income, which is not.

An additional incentive is the Qualified Business Income deduction. The Tax Cuts and Jobs Act introduced a 20% deduction on qualified business income from an S-Corp. However, the wages paid to S-Corp owners reduce the qualified business income passed through to the owner since the S-Corp deducts the wages as a business expense. Therefore, owners are incentivized to minimize their wages to maximize the qualified business income, which in turn maximizes the 20% deduction.

The term “reasonable compensation” is somewhat ambiguous, as the IRS does not provide a specific formula to calculate it. The IRS generally defines reasonable compensation as the amount that would ordinarily be paid for similar services by similar businesses under similar circumstances. Factors that may be considered in determining reasonable compensation include the owner’s roles and responsibilities, time and effort devoted to the business, training and experience, and what other businesses pay for similar services.

The IRS has a history of scrutinizing S-Corps to ensure that reasonable compensation is being paid, especially if there’s no record of compensation paid to owner-employees. Failure to pay reasonable compensation can lead to the recharacterization of distributions as wages, resulting in back taxes and penalties.

While deciding how much to pay yourself as an S-Corp owner, you should consider your business’s unique circumstances and industry standards. You can leverage industry statistics, employer-review sites, and professional services that specialize in reasonable compensation analysis to help determine a fair salary. It’s vital to document your decision-making process when setting your compensation and keep all supporting documentation.

Final Thoughts

The purpose of this document is to provide a brief overview of taking reasonable compensation from an S-Corp and is not a substitute for speaking with one of our expert advisors. If you would like to discuss your unique situation and learn more about maximizing your tax savings while staying within IRS guidelines, please contact our office. We're always happy to help.

About Larson Gross

Ted Larson and Dennis Gross founded our firm in 1949. They built the business based on excellence, passion, integrity, trust and pro-action — values still important to us more than seven decades later.

Even well into their retirement years, Ted Larson and Dennis Gross continued to have the best interest of the firm at heart. Mr. Larson would come into the office on a regular basis to meet every new face and make a personal connection with each of our team members. He remembered the name of every employee, as well as the names of their spouses and children, and would greet clients by name as he passed by the reception desk. Sometimes, you'd even find a newspaper clipping on your desk that Mr. Larson dropped off, highlighting that your son made the honor roll. This is the example of a genuine relationship we strive to embody with our people and clients.

Today, we're led by ten partners who are growing our firm with respect for where we've come from and a new vision for future success. Our 120-plus team members and three offices located in Bellingham, Lynden and Burlington make us the 10th largest public accounting firm in the Puget Sound region. While we're determined to expand our impact and help strengthen as many businesses and individuals as we can, we're also committed to remaining a locally-owned organization. We're incredibly proud of where we've come from and look forward to a future of possibility

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