What is Reasonable Compensation?

A Primer for S-Corp Owners

Reasonable Compensation in a Nutshell

1. All S-Corp shareholder-employees **must** pay themselves a reasonable salary (i.e. Reasonable Compensation) via W-2 **BEFORE** any distributions are taken. It's the law.

2. You should complete a Reasonable Compensation analysis each year using one of the three IRS-approved approaches.

3. Keep a record of all supporting documentation for your figure each year.

There are many tax benefits to filing as an S-Corp, but you should be aware of the additional responsibilities you have including:

- S-Corp shareholder-employees must pay themselves reasonable wages (i.e. Reasonable Compensation) via W-2 before taking any distributions from the business

- You will need to file an additional tax return for the business as an S-Corp

- Some states impose additional fees to S-Corps

- There may be filing fees associated with becoming an S-Corp

If you aren't sure if an S-Corp is right for you, ask your accounting professional to run an Entity Planning Analysis to see what makes the most sense for your business.

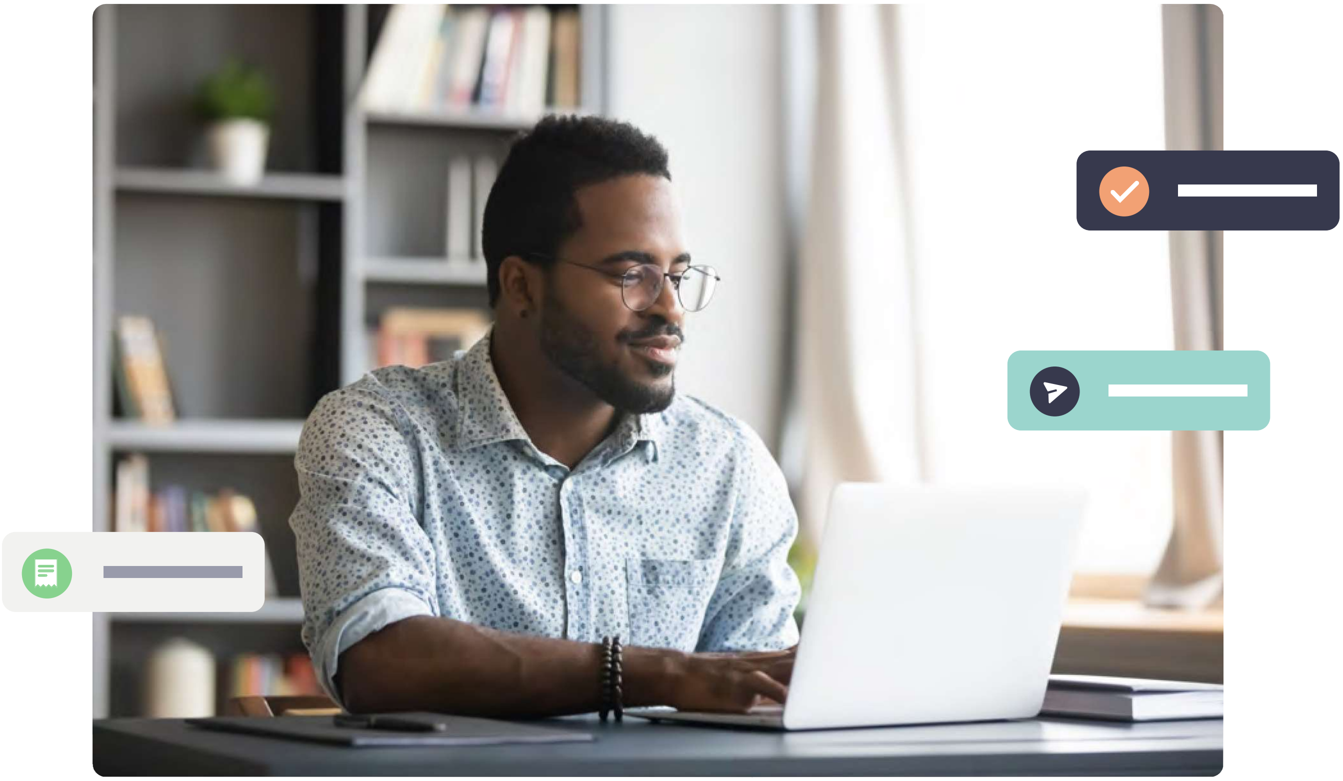
What is Reasonable Compensation?

The biggest struggle for most S-Corp owners is defining Reasonable Compensation. The IRS defines Reasonable Compensation as: the value that would ordinarily be paid for like services by like enterprises under like circumstances. ~ IRS Code: Section 162-7(b)(3)

To put it in simpler terms, you can ask yourself, “How much compensation would be paid for this same position, held by a non-owner in an arms-length employment relationship, at a similar company?”

A few key things to keep in mind:

- Reasonable Compensation is based on the value of the service provided, not profits or distributions.
- Wages (i.e. Reasonable Compensation) should be paid before distributions and must be paid via W-2.
- A shareholder-employee can take wages without taking a distribution, but not vice versa.
- A shareholder-employee who does not want to take Reasonable Compensation can refuse all compensation and play “catch-up” in a later year.



Consult your accounting professional before making any decisions.

How Do You Calculate Reasonable Compensation?

The IRS defines three approved approaches to calculate Reasonable Compensation: the Cost Approach, Market Approach, and Income Approach. Each approach is useful in different situations and your accounting professional can help determine the appropriate approach to use based on your business.

Here are some helpful tips when it comes to Reasonable Compensation:

1. **Run a Reasonable Compensation analysis every year.** Just like wages can change over time, so can Reasonable Compensation. What was considered reasonable 5 years ago is most likely no longer accurate.

2. **Document your Reasonable Compensation figure.** Keep a record of all data used and all calculations completed to arrive at your Reasonable Compensation figure each year. This will come in handy should you ever be audited.

3. **Use unbiased data.** If you are ever audited, the IRS will be looking to see that you used unbiased data for your calculations – that is, data that is not influenced by an interested party and meets criteria to be determined accurate. Often sites like Glassdoor and Payscale are considered biased because the sample sizes and reporting methods can result in inaccurate data. Look for sites using sources such as the Bureau of Labor Statistics and the U.S. Census Bureau.

What Happens if I Don't Take Reasonable Compensation?

If you don't take Reasonable Compensation but you do take distributions from the business, you are opening yourself up to potentially large financial consequences including back taxes, penalties, and interest levied by the IRS. The IRS can also revoke your S-Corp status and they have been known to levy preparer penalties on tax preparers (i.e. your tax accountant).

The bottom line: If you file as an S-Corp, all shareholder-employees must take a reasonable salary via W-2 before taking any distributions.

EZ E-File Tax Preparers

EZ E-FILE TAX PREPARERS, INC
925.960.1450
info@ezefiletax.com
www.ezefiletax.com