



"IRS Guidelines for Determining Reasonable Compensation in S-Corps"

The concept of "reasonable compensation" is critical for S-Corporations, including LLCs that have elected to be taxed as an S-Corp. The IRS requires that owner-employees of S-Corps pay themselves a reasonable salary for the work they perform before taking profits as distributions. This is important because salaries are subject to payroll taxes, whereas distributions are not, and the IRS closely scrutinizes whether owners are paying themselves fairly to avoid tax underpayment.

While there is no fixed formula, to determine what constitutes reasonable compensation, the IRS examines several factors. First, it considers the duties and responsibilities of the owner. The more significant and complex the tasks the owner performs, the higher the salary should be. Additionally, industry standards play a key role. The IRS expects that an owner's salary will be comparable to what a non-owner employee in a similar position would earn in the same industry, business size, and geographical area.

The experience, education, and qualifications of the owner are also important considerations. Owners with more skills and experience should command higher pay for their services. The IRS also looks at the number of hours worked; owners who work full-time should receive a salary reflecting their full-time involvement, while part-time owners may justify lower pay.

Another critical factor is the overall revenue and profitability of the business. Companies generating significant income and profits should pay their owner-employees proportionally higher salaries. Similarly, the compensation of other employees in the company is a useful benchmark. If non-owner employees in similar roles are paid higher salaries, the IRS expects that the owner should at least match or exceed that level of pay.

Additionally, if an owner receives other types of compensation, such as bonuses, perks, or benefits, these can be factored into the total compensation package. Finally, the IRS considers how much time the owner devotes to the business, especially if they are involved in other ventures, which can affect what is considered reasonable.

Failure to pay reasonable compensation can result in penalties and reclassification of distributions as wages, which would subject them to payroll taxes. The IRS may audit businesses that underpay their owners, applying back taxes, interest, and penalties if it finds that the salary was too low.

Ultimately, the guiding principle for determining reasonable compensation is that the salary should reflect what the business would pay someone else to do the same job under similar circumstances. By ensuring their compensation aligns with these factors, S-Corp owners can avoid IRS scrutiny while maintaining compliance with tax regulations. If you have any specific questions, feel free to contact me, Herman S. Chatrath, Esq. at (559) 248-4820.

About the Author:



Herman S. Chatrath is an attorney in Coleman & Horowitz's Fresno office, where he represents companies and their owners in business, real estate, construction, and estate planning matters. A graduate of Loyola Law School, Herman brings a strong background in commercial real estate, having managed large portfolios of apartment and office buildings, as well as overseeing non-performing loans for a private real estate company with assets over \$4 billion. During law school, he excelled in Moot Court, achieving a top-ten brief placement, and served on the Transaction Negotiation team, where he successfully negotiated the mock acquisition of an \$800 million company. His legal experience also includes clerkships with the Los Angeles County District Attorney's Office, McCormick Barstow in Fresno, and Coleman & Horowitz.

About the Firm:

Established in 1994, Coleman & Horowitz, LLP is a state-wide law firm focused on delivering responsive and value-driven service and preventive law. The Firm represents businesses and their owners in matters involving transactions, litigation, agriculture & environmental regulation and litigation, intellectual property, real estate, estate planning and probate. Attorneys at the firm also serve as mediators, arbitrators, and discovery referees.

The Firm has been recognized as a "Top Law Firm" (Martindale Hubbell) and a "Go-To" Law Firm (Corporate Counsel). From six offices in California, and the Firm's membership in Primerus, a national and international society of highly rated law firms (www.primerus.com), the Firm has helped individuals and businesses solve their most difficult legal problems. For more information, see www.ch-law.com and www.Primerus.com.

Disclaimer: This article is intended to provide the reader with general information regarding current legal issues. It is not to be construed as specific legal advice or as a substitute for the need to seek competent legal advice on specific legal matters. This publication is not meant to serve as a solicitation of business. To the extent that this may be considered as advertising, then it is expressly identified as such.