

Reasonable Compensation for Shareholders



2025

NATP™

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NATP™

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NATP exists to be the most reliable resource for gaining and developing professional tax expertise. The design of this publication is to provide accurate and authoritative information on the subject matter covered, presented with the understanding that the National Association of Tax Professionals is not engaged in rendering legal or accounting services.

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NATP updated this material to 2025. At the time of updating, the most recent authorized forms are for 2024. Therefore, we used 2024 forms throughout the text for examples and illustrations.



Course Description

Shareholders of an S corporation generally must receive reasonable compensation for services they provide to their S-corp. Tax professionals can help their clients establish reasonable compensation by analyzing various factors. They should also be prepared to explain the potential tax implications when reasonable compensation has not been taken. This course reviews the key aspects of reasonable compensation for S corporation shareholders.

Objectives

Upon completion of this course, you will be able to:

- List several factors courts have analyzed to establish reasonable compensation
- Explain how to substantiate reasonable compensation
- Examine the tax consequences when shareholders fail to take reasonable compensation

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History

For many years, the Treasury Inspector General for Tax Administration (TIGTA) has been concerned that S corporation shareholders are underpaying or not paying themselves at all to avoid paying employment taxes.

Most recently, on Aug. 11, 2021, TIGTA issued a Final Audit Report, *Efforts to Address the Compliance Risk of Underreporting of S Corporation Officers' Compensation are Increasing, but More Action Can Be Taken* (Report Number 2021-30-042). TIGTA's overall objective was to determine whether the IRS's policies, procedures and practices adequately ensure that compensation is considered in examinations of closely held S corporations and its shareholders.

In general, TIGTA found the IRS audits less than 1% of S corporation returns. Furthermore, when the IRS audits Form 1120-S, *U.S. Income Tax Return for an S Corporation*, nearly half the revenue agents do not evaluate officer's compensation, even when the sole shareholder has not reported officer's compensation but has taken tax-free distributions.

More specifically, for processing years 2016-2018, TIGTA identified 266,095 S corporation returns with profits greater than \$100,000, one shareholder and no officer's compensation that were not selected for a field examination. These sole-shareholder owners had profits of \$108 billion and took \$69 billion in distributions without reporting officer's compensation. TIGTA estimated nearly \$25 billion in compensation was not reported on these returns, which means they avoided paying approximately \$3.3 billion in FICA tax.

When it comes to S corporation compliance regarding officer's compensation, the IRS uses several approaches, including:

- Examiners within the Small Business/Self-Employed (SB/SE) Division may (but are not required to) review officer's compensation as part of an S corporation audit (field examination)
- Exam Case Selection within the SB/SE Division's Specialty Examination Employment Tax Program identifies returns with potential employment tax noncompliance using Form 1120-S and certain criteria
- Compliance Initiative Projects (CIP) focus resources on the issue
 - In 2009, the IRS created a CIP to address the officer's compensation issue using filters that identify high-risk cases (e.g., S corporations with no officer compensation reported, which can result in an assessment to the S corporation's employment tax returns)
 - In August 2020, the IRS began its newest CIP to focus additional resources for S corporations lacking officer's compensation

TIGTA made the following recommendations to the commissioner, SB/SE Division:

- Evaluate the risk of noncompliance associated with officer's compensation in S corporation returns and update the examination plan

- Evaluate the benefits to using a threshold and specific criteria (e.g., when profits, distributions or loans exceed a certain amount) to make the officer's compensation issue mandatory for field examiners
- Use compliance results from established workstreams within the Specialty Examination function, in conjunction with CIP compliance results, to inform decision-making around the consideration of proactive alternative treatments

Even though the IRS is expanding its S corporation examination efforts, coverage of the officer's compensation issue can be improved according to TIGTA.

Corporate Officers

In general, if an S corporation shareholder performs more than minor services for the corporation as an officer and receives remuneration in any form, treat them as an employee of the corporation [Rev. Rul. 73-361, §3121(d)(1) and Reg. §31.3306(b)-1(c)]. Employees receive wages reported on Form W-2, *Wage and Tax Statement*. Thus, wages received by an officer of the corporation are subject to the *Federal Insurance Contributions Act* (FICA), the *Federal Unemployment Tax Act* (FUTA) and federal income tax withholding (FITW).

Do not report compensation paid to S corporation shareholders as self-employment income on Form 1099-NEC, *Nonemployee Compensation*, unless they only performed services as a member of the board of directors.

Note: Under Reg. §31.3121(d)-1(b), an officer is not considered an employee if they do not perform any services or only perform minor services and do not receive or are not entitled to receive, directly or indirectly, any remuneration. A director of a corporation acting in that capacity is not an employee.

Sole proprietors and partners generally pay self-employment (SE) tax on all their net income from the business. However, undistributed pass-through income from an S corporation is not subject to SE tax (Rev. Rul. 59-221). As a result, S corporation shareholders may be motivated to minimize the wages they receive to reduce or avoid employment taxes. Although shareholders pay income tax on their share of the taxable pass-through income, they do not pay SE tax on it. Thus, they would rather increase their taxable pass-through income than take wages subject to employment taxes.

Note: The tax savings do not come from the SE tax alone. The savings are generally slightly lower since a self-employed taxpayer is allowed a deduction for one-half of the SE tax.

In general, the cost saving is 15.3% of the amount that is not classified as wages. However, this cost saving should be weighed against other costs, such as the cost of accounting fees and payroll compliance.

Example

Jason, single, owns a limited liability company (LLC) that is taxed as a disregarded entity, so the business activity is reported on Schedule C. Jason's net taxable income is projected to be \$101,000 for the current year. Jason asks for advice in determining whether the S election is advantageous for him

His tax professional presents the following chart. This assumes \$60,000 is reasonable compensation for his services, and Jason will claim a standard deduction of \$14,600 (2024) for a single person. Jason is in the 22% tax bracket with or without the S election. However, he still saves \$2,649 (\$23,278 - \$20,629) in total taxes by making the S election, mainly due to the difference in Social Security and Medicare taxes (FICA).

	Without S Election		With S Election	
Income subject to FICA taxes	\$101,000		\$60,000	
	x 92.35%			
	x 15.3%		x 15.3%	
FICA taxes	\$14,271	A	\$9,180	
Total income	\$101,000		\$101,000	
Deduction for FICA taxes	- 7,136		- 4,590	
Standard deduction	- 14,600		- 14,600	
Qualified business income deduction (QBID)	-15,853		- 7,282	
Taxable income before QBID	63,411		74,528	
Income tax	\$9,007	B	\$11,449	
Total tax (A + B)	\$23,278		\$20,629	

Distributions (taxable or nontaxable) from an S corporation are not subject to employment taxes either. As a result, shareholders may be tempted to take distributions instead of paying themselves wages.

Note: Remember to consider state unemployment tax. Most states do not tax a sole proprietor, but they assess state unemployment tax on the sole shareholder of an S corporation.

Example

Angela is the sole shareholder and employee of Professionals4U, Inc., an S corporation. Professionals4U generates taxable income of \$100,000 before paying Angela any compensation. Angela decides she is going to pay herself wages of \$80,000.

Assuming an effective federal unemployment tax rate of 0.6% on the first \$7,000 of wages, total employment taxes are calculated as follows:

	Employee	Employer	Total
Social Security	\$4,960	\$4,960	\$ 9,920
Medicare	1,160	1,160	2,320
Federal unemployment	0	42	42
Total employment taxes	\$6,120	\$6,162	\$12,282

Angela's \$80,000 salary results in total employment taxes of \$12,282.

Alternatively, if Angela took an \$80,000 distribution instead of wages, she saves \$12,282 in employment taxes. However, the IRS could recharacterize some or all of her distribution as wages to the extent the payment represents reasonable compensation for services she provided to the S corporation (discussed later).

Reasonable Compensation

To claim a business deduction for compensation, the amount paid must be reasonable for the personal services rendered [§162(a)(1)]. For this purpose, two tests must be met:

- Amount test – focuses on the reasonableness of the total amount paid
- Purpose or intent test – examines the services for which compensation was paid

Typically, if services were performed, the first test is the main issue examined by the courts.

S corporation shareholders must receive reasonable compensation for services provided to their S corporation (other than minor services) before they can receive other payments from the corporation (e.g., distributions). Otherwise, such payments may be recharacterized as wages (discussed later).

In addition, all family members of an S corporation shareholder must receive reasonable compensation for services rendered or capital furnished to the corporation, even if they do not own any stock in such corporation [§1366(e)]. For this purpose, family members are defined under §704(e)(2), which only includes the shareholder's [Reg. §1.1366-3(a)]:

- Spouse
- Ancestors (e.g., parents, grandparents, etc.)
- Lineal descendants (e.g., children, grandchildren, etc.)
- Any trusts for the primary benefit of any of these persons

The Internal Revenue Code (IRC) and Treasury Regulations do not provide specific guidelines for establishing reasonable compensation. In general, reasonable compensation equals the amount that would ordinarily be paid for like services by like enterprises under like circumstances [Reg. §1.162-7(b)(3), Reg. §1.1366-3(a)]. This regulation is vague at best, and each situation is unique.

To determine reasonable compensation, examine all the facts and circumstances existing at the date the contract for services was made, not the circumstances existing at the date the contract is questioned [Reg. §1.162-7(b)(3)]. Several factors must be analyzed when making this determination (discussed later). In addition, consider the shareholder's total compensation, or all items of compensation, including:

- Wages and bonuses (cash or noncash)
- Fringe benefits (Rev. Rul. 92-93)
- Retirement plan contributions (Edwin's Inc., v. U.S., 34 AFTR 2d 74-5805)

Reasonable compensation depends on all the facts and circumstances, but it never exceeds the amount received by the shareholder either directly or indirectly (Fact Sheet 2008-25). In other words, if shareholders do not pay themselves compensation but do not receive any payments from the S corporation, their compensation may be zero.

Example

In 2025, A&A, Inc. made a late S election with an effective date of Sept. 15, 2024 (date corporation's first tax year began). The business started in October 2024, but the sole shareholder, Aaron, did not receive any compensation for substantial services provided to A&A during 2024. Is this a problem?

It depends. If Aaron did not receive any payments (e.g., no distributions) from A&A during 2024, his wages for such year may be zero. Even though he provided substantial services to the corporation, reasonable compensation cannot exceed the amount received, directly or indirectly, from the corporation. This could happen in the early years when the corporation is not profitable or has cash flow problems.

Factors

The courts have provided numerous factors to use when determining reasonable compensation. These factors are not all-inclusive, and some factors may be given greater weight than others.

In *Elliotts, Inc.*, 52 AFTR 2d 83-5976, the court presented a list of five broad categories of factors to consider, including:

- Shareholder's role in the corporation, considering the position held, hours worked, duties performed and general importance of the shareholder to the success of the company
- External comparison of wages paid for similar services by similar companies to shareholder's wages
- Character and financial condition of the corporation
- Conflicts of interest in setting compensation levels when an exploitable relationship exists between the corporation and its sole shareholder
- Internal consistency, meaning the corporation's compensation policy for all employees is reasonable, longstanding and consistently applied

Other cases involving reasonable compensation looked at additional factors. For example, *Boca Construction, Inc.*, TC Memo 1995-5 reviewed the following factors:

- Employee's qualifications
- Nature, extent and scope of employee's work
- Size and complexity of the business
- Salaries paid in comparison to gross and net income
- General economic conditions
- Salaries paid in comparison to distributions to shareholders and retained earnings
- Salary policy to all employees
- Corporation's financial condition
- Prevailing rates of compensation for comparable positions in comparable companies
- Compensation paid in prior years
- Whether the shareholder and S corporation dealt at arm's length
- Whether the shareholder guaranteed the S corporation's debt

Some courts have even looked to whether investors would conclude there is an appropriate return on investment after taking the shareholder's wages into account.

Note: To determine reasonable compensation, analyze every factor. One factor alone generally does not establish reasonable compensation.

IRS guidance

The IRS has provided some information on its website (www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues), which states the key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation by looking at the source of the S corporation's gross receipts.

The three major sources include:

- Services of the shareholder
- Services of nonshareholder-employees
- Capital and equipment

In general, to the extent the S corporation's gross receipts are generated by the shareholder's personal services, payments to such shareholder should be classified as wages. A shareholder should also receive wages if they perform administrative work for other income-producing employees or assets. On the other hand, payments to a shareholder should not be treated as wages to the extent gross receipts are generated by the services of non-shareholder employees or capital and equipment.

The IRS also listed the following factors to use in determining reasonable compensation:

- Training and experience
- Duties and responsibilities
- Time and effort devoted to the business
- Dividend history
- Payments to non-shareholder employees
- Timing and manner of paying bonuses to key people
- What comparable businesses pay for similar services
- Compensation agreements
- Use of a formula to determine compensation

In 2014, the IRS issued a Reasonable Compensation Job Aid for IRS Valuation Professionals. This reference is more than 10 years old and cannot be used or cited as authority. However, it may provide some insight into how the IRS determines reasonable compensation. The IRS uses three valuation methods, including the:

- Market approach (most common)
- Income approach
- Cost approach (least common)

The following chart summarizes these methods.

Method	Description
Market	Determine how much compensation would be paid to a non-shareholder in a similar company for the same position
Income	Apply the independent investor test using the FMV of the company each year and determine if investors obtained a far higher return on investment than reasonably expected, which presumes compensation is reasonable
Cost	Allocate the employee's time to various job duties based on the hours spent on each duty, determine the compensation for each job duty using salary surveys for comparable part-time positions, and calculate total compensation by adding up the compensation for each job duty

All three methods are considered. However, the IRS relies heavily on the market approach by comparing compensation for similar positions in similar companies. The resulting reasonable compensation amount is then refined using the income and cost approaches.

Note: For more information, the Job Aid can be found on the IRS website: www.irs.gov/pub/irs-lbi/Reasonable%20Compensation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf.

Court case

JD & Associates, Ltd. v. United States, No. 3:04-cv-59 (D.N.D. May 2006), highlights which factors the North Dakota District Court analyzed in determining reasonable compensation.

JD & Associates, Ltd. (JDA) was an S corporation that provided tax and accounting services. It was owned by one shareholder, Jeffrey Dahl, who was a CPA with more than 20 years of experience. Some of Dahl's responsibilities included, but were not limited to, managing JDA, maintaining JDA's books and records, preparing tax returns, performing bookkeeping services and reviewing financial statements.

Despite all these responsibilities, Dahl only had a salary of \$19,000 in 1997 and \$30,000 in both 1998 and 1999. In addition to his salary, he took tax-free distributions of \$47,000 in 1997 and \$50,000 in both 1998 and 1999.

The IRS determined Dahl's compensation was unreasonably low in comparison to his responsibilities as the managing shareholder of JDA. The IRS hired an expert, a certified valuation engineer, who determined reasonable compensation for Dahl was \$61,817 for 1997, \$63,672 for 1998 and \$65,582 for 1999. The IRS expert used a national survey of financial ratios published by Risk Management Associates (RMA) and compared them to the financial ratios of JDA. The expert found that JDA's after-tax profit as a percentage of net sales was 208%-374% more profitable than its peers during 1997 through 1999. Furthermore, Dahl's salary as a percentage of net sales was 166%-266% less than that of his peers during the same years.

The court reached a decision in favor of the IRS. The court grouped numerous factors into the following three broad categories:

- Performance of the employee. The court found Dahl's performance as managing shareholder of JDA was exemplary. JDA had profits far in excess of the profits generated by comparable accounting firms. Thus, his compensation was inconsistent with his performance.
- Salary comparisons. The court found Dahl's salary compared to other employees was unreasonable. Despite the additional duties he had and the firm's success, his compensation was slightly above that of his employees. He also never received a raise from 1998-1999, even though other employees did.
- Company conditions. The conditions of the company dictated higher pay for the managing shareholder. JDA was a small enterprise that required little in terms of reinvestment. This fact contributed to low overhead, which freed up capital for employee compensation. In addition, JDA saw continuous growth every year, so this profitability allowed for a higher salary than Dahl actually received.

Steps to Establish Reasonable Compensation

After analyzing the previously mentioned factors, an S corporation can take the following steps to prove the shareholder's salary is reasonable.

- Use salary surveys for specific industries such as the 2025 Salary Guide from Robert Half (www.roberthalf.com/us/en/insights/salary-guide) or resources such as O*NET OnLine (www.onetonline.org) or the Bureau of Labor Statistics (www.bls.gov) to establish wages paid for like services by like enterprises under like circumstances. The BLS website contains national and state-specific information regarding average annual wages paid for different occupations. Analyze and document the following:

- Nature of the S corporation's business – a personal service business generally has higher profits generated by the personal efforts of its employees, including shareholder-employees. As a result, a significant portion of its profits should be paid out in compensation rather than distributions.
- Shareholder's qualifications, responsibilities, time devoted to the business and salary – preferably, do this at the beginning of the year through an employment contract or the corporate minutes. Generally, corporations have been more successful when compensation is set by minority shareholders or an independent compensation committee based on predetermined formulas tied to performance.
- Shareholder's compensation in comparison to nonshareholder compensation – a shareholder-employee, who has greater responsibilities than the highest paid nonshareholder-employee, should receive higher wages than the nonshareholder-employee.
- Shareholder's compensation in current year as compared to compensation received in prior years – generally, the shareholder-employee's salary should increase as the S corporation's revenue increases. Otherwise, the shareholder's wages may be unreasonably low.
- Financial ratios published by RMA or other industry-specific publications in comparison to the S corporation's financial ratios – the shareholder's compensation may be unreasonably low if the:
 - S corporation's after-tax profit as a percentage of net sales is much higher than that of similar companies in the same geographic location
 - Shareholder's compensation as a percentage of the S corporation's net sales is much lower than that of their peers
- Avoid making any distributions or loan payments if the shareholder receives no wages. If an S corporation does not have the cash to pay wages to the shareholder, it should document the cash flow issues in the corporate minutes. Once the S corporation has a positive cash flow, it should resume paying the shareholder reasonable compensation.

Other methods used in practice

In practice, tax professionals often use other methods to establish reasonable compensation, including, but not limited to:

- Fraction of net income
- Loan to shareholder reclassified as wages
- Wages or salary

When using one of these methods, determine whether the amount paid is reasonable by comparing the shareholder's wages to the amount the S corporation would have had to pay another individual to perform the same services.

Fraction of net income

Some tax professionals use a fraction of net income (50/50 or 60/40) to establish reasonable compensation for S corporation shareholders. However, this is a haphazard method done in practice, which may not equal reasonable compensation. For example, it might not equal wages paid for like services by like businesses under like circumstances. It is an “easy” measure of compensation, but there is no legal authority for such an arbitrary split.

Exercise extreme caution with this method because it creates logistical issues, such as determining:

- Which fraction of net income to use
- How the amount paid compares to other companies in the same industry
- How much to pay when there is a net loss for the company
- How to pay consistent wages during the year when income fluctuates

Example

Gerald is a tax professional with a client who is a direct mail advertiser and usually paid on commission. The industry standard is to pay the direct mail salesperson 20% of the revenue as a commission; the rest being profit for the company.

Gerald advises his client to do the same, withholds payroll taxes in each respective quarter and makes payroll tax deposits. The remaining 80% covers overhead, which is always sufficient to produce a profit.

In general, the fraction used in this scenario is reasonable (20/80) because it is based on industry standard. While this is not ironclad, at least it is not based on an arbitrary standard.

Loan to shareholder reclassified as wages

Many sole shareholders depend on the S corporation's cash inflow to pay their personal living expenses. It may be difficult to track these personal expenses and report them as wages throughout the year. Some tax professionals simply treat amounts withdrawn throughout the year for personal expenses as a loan to the shareholder. Then they reclassify the loan to wages at year-end in the fourth quarter. This is an arbitrary solution that leaves both the tax professional and the taxpayer subject to significant penalties if they fail to file and deposit payroll taxes throughout the year.

Example

Gerald is a tax professional who advises his client, Ronaldo, to use a 60/40 split in determining reasonable compensation. In years of net income, 60% will be classified as wages and 40% will be considered a distribution.

Throughout the year, Ronaldo withdrew \$30,000 for personal living expenses. During the year, Gerald classified these payments as a loan to the shareholder. At year-end, Gerald determines the net profit is \$60,000. Thus, reasonable compensation is \$36,000 ($\$60,000 \times 60\%$). Gerald reclassifies the \$30,000 loan amount to wages and Ronaldo takes another \$6,000 in wages at the end of the fourth quarter, so his total compensation is \$36,000 ($\$30,000 + 6,000$). The S corporation files the applicable payroll tax return and pays the payroll taxes.

Not only is this arbitrary, but it does not reflect economic reality. The personal expenses paid throughout the year should not be classified as a loan because Ronaldo never intended to repay such amount. Furthermore, no analysis was done to determine if \$36,000 is reasonable compensation. Based on these facts, this is an improper method of determining compensation.

Wages or salary

The wages or salary method may be useful for professional firms (e.g., accounting or law firms). Many professional firms charge a “billable hour,” which is work performed by an employee of the firm that can be billed to a client at the firm’s hourly rate.

Example

John is an attorney and a shareholder in his S corporation. The firm’s hourly billable rate is \$175 per hour. John works two hours doing research and administrative work that cannot be billed to a specific client, but he works six hours preparing for a client’s litigation case. The firm can bill \$1,050 ($\$175 \times 6$), but the rest is unbillable. The firm determines John’s appropriate wage is \$40/hour. Thus, John is paid \$320 ($\$40 \times 8$) for both unbillable and billable time, but the income billed for the day is \$1,050.

Using a billable hour for professional services while paying the professional on a reasonable hourly basis can provide a window of profitability that is not subject to payroll or self-employment tax. It can also provide a sound measure for setting a wage based on the shareholder’s experience, time involved in the company and the going rate if the position were to be filled by another person.

Note: For tax reasons alone, this may not be used much as a practical matter for some professional firms. Attorneys often exceed the Social Security wage limit, which diminishes the usefulness of using an S corporation as a tax-saving strategy. In addition, using an S corporation to reduce SE tax may not be advantageous for a professional firm wanting to perform special allocations of income.

Example

José owns his own bakery. He is the only employee and performs various functions, such as baking products for sale and operating the cash register. He determines that these positions, based on the functions involved, pay between \$13-\$18 per hour in his area, which abides by the minimum wage rules. José works about 50 hours per week and establishes his wage to be \$15 per hour. Thus, his wages are \$750 (\$15 x 50) per week.

Example

José owns his own bakery. However, it has been operating at significant losses after he determined his wage to be \$15 per hour. Even though he is still working 50 hours per week, he only pays himself \$500 per week. Depending on economic conditions and the prospect of the bakery recovering, this may be considered reasonable based on the factors presented earlier, which allows him to postpone a significant portion of his wages.

Example

José owns a bakery. Rather than renting, he invested \$200,000 to purchase a building, equipment and some other capital outlays. It's arguable that a significant portion of his income comes from this capital investment, which weighs in his favor for supporting a lower wage.

As a practical matter, shareholders may wish to see a consistent paycheck and abstain from documenting their time on timesheets. Such shareholders may benefit from establishing a salary instead.

Example

José reasonably predicts his net income will be enough to pay at least a \$2,000 per month salary. This allows him to establish his household budget around a steady income. This can be reasonable; however, if the business income increases when José works substantially more hours, he should consider declaring a bonus to keep his compensation in line with what is reasonable.

Tax Consequences if Compensation Unreasonable

If an S corporation shareholder performs more than minor services for the corporation and does not receive reasonable compensation, the IRS can recharacterize payments from the S corporation to such shareholder as wages, but only to the extent the IRS determines such payments are disguised compensation. In this case, the S corporation must file payroll tax returns and deposit employment taxes. In addition, it could be subject to various penalties.

Payments recharacterized

If an S corporation has accumulated earnings and profits (AE&P) and pays dividends instead of reasonable compensation, the IRS may recharacterize these dividends as wages subject to FICA, FUTA and FITW (Rev. Rul. 74-44). In addition, all or part of the shareholder's nondividend distributions may be recharacterized as wages subject to employment taxes, even if the shareholder received wages but they were unreasonably low.

Note: In the Form 1120-S instructions for Lines 7 and 8, the IRS provides the following caution:

“Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation.”

In addition, when taxpayers receive Notice CP261 stating the IRS has accepted their S corporation election, the notice says:

Keep in mind

Payments to shareholder-employees for services rendered:

- You must determine a reasonable salary when a shareholder-employee of an S corporation provides services to the corporation.
- Payments to a shareholder-employee for services provided to an S corporation are wages and are subject to employment taxes.
- We may re-characterize distributions paid to a shareholder as salary if the distribution was paid in lieu of reasonable compensation (Revenue Ruling 74-44).

Shareholders also attempt to receive tax-free money from S corporations using loans from the S corporation to the shareholder. However, the IRS can reclassify these loan payments as wages if they represent reasonable compensation for services provided to the corporation.

To avoid this type of reclassification, it must be a bona fide loan. In general, there should be a loan agreement in place charging appropriate interest, cash payments according to a specified repayment schedule and security for the loan.

In general, to determine if loans to shareholders are bona fide, ask the following questions:

- Is there written documentation detailing the terms of the loan, such as a formal repayment schedule?
- Is repayment required over a period of years or on demand?
- Is the interest rate at market or below market?
- Is the loan listed on the S corporation's balance sheet as a receivable?
- Are the terms of the loan being followed (e.g., shareholder is making payments on the loan)?

Court cases

The following court cases provide the factors, ratios and data the IRS analyzed to determine reasonable compensation for an S corporation shareholder-employee and the payments that were recharacterized as wages. All S corporations should do the same analysis to determine reasonable compensation for their shareholder-employees.

Watson case

In *David E. Watson, P.C. v. U.S.*, 109 AFTR 2d 2012-1059, the court, citing the shareholder's 20 years of experience, advanced degree and hours worked per week, held that the shareholder received an unreasonably low salary and reclassified a portion of his distributions as salary.

David Watson was a CPA who had a bachelor's degree in business administration with a specialization in accounting and a master's degree in taxation. He was the sole shareholder, employee, officer and director of David E. Watson, P.C., an S corporation.

Watson's S corporation owned a 25% interest in Larson, Watson, Bartling & Juffer, LLP (LWBJ), a successful accounting firm. Although Watson was an employee of his S corporation, he provided services exclusively to LWBJ through his S corporation.

During 2002 and 2003, LWBJ's gross revenue exceeded \$2 million each year. However, Watson only authorized for himself an annual salary from the S corporation of \$24,000 for 2002 and 2003. In addition to this salary, Watson received distributions from his S corporation of \$203,651 and \$175,470 in 2002 and 2003, respectively. The money to make these distributions came from LWBJ's profit distributions to Watson's S corporation.

The IRS maintained Watson's compensation was unreasonably low based on the services he provided and reclassified a portion of his distributions as compensation. In doing so, the IRS assessed the S corporation employment taxes on the reclassified salary.

David E. Watson, P.C. contended that it clearly intended to pay compensation of \$24,000 per year to Watson and the amounts distributed in excess of compensation were properly classified as distributions and/or loans. Furthermore, it argued that the United States does not have the authority to require David E. Watson, P.C. to pay any sort of minimum salary to its shareholder before it can pay distributions and the United States' ability to assess additional employment taxes is limited to taxing payments that were intended to be compensation. David E. Watson, P.C. stated that it was the corporation's intent to pay Watson an annual salary of \$24,000. It urged the court to focus on intent instead of reasonableness. The court disagreed with this argument and stated that an analysis must be done to determine whether the distributions were made as remuneration for services performed.

Using RMA annual statement studies, the IRS expert determined the health of David E. Watson, P.C. and found the corporation was at least three times more profitable than comparably sized firms in the accounting field. Additionally, the IRS expert determined that individuals in positions secondary to Watson were paid significantly more in compensation.

To determine reasonable compensation, the IRS expert used a Management of an Accounting Practice (MAP) survey conducted by the AICPA that was specific to the corporation's location. Based on the survey, the IRS expert determined that, on average, owners of an accounting firm billed at a rate approximately 33% higher than a director. The IRS expert grossed up the average director compensation of \$70,000 by 33% to arrive at a reasonable annual compensation of \$93,000, which was decreased to \$91,044 to account for nontaxable fringe benefits. However, Watson only received \$24,000 in wages, so \$67,044 ($91,044 - 24,000$) of his distributions were reclassified as wages.

Glass Blocks case

In *Glass Blocks Unlimited*, TC Memo 2013-180, the court reclassified all purported loan repayments and distributions as compensation.

Fredrick Blodgett was the sole shareholder and only employee of Glass Blocks Unlimited, an S corporation. The corporation sold and distributed glass blocks for the real estate market in North America. Blodgett was responsible for all operational and financial decisions of the corporation and performed nearly all the work necessary to run the business.

Over a two-year period, Glass Blocks Unlimited made cash payments totaling \$62,488 to Blodgett. Glass Blocks Unlimited did not treat the payments as wages. Instead, the payments were in part loan repayments and in part distributions. The IRS contended that the payments represented wages and assessed a payroll tax deficiency of \$9,560.64 and \$3,605.50 in penalties under §§6651(a)(1) and 6656.

Glass Blocks Unlimited did not dispute that Blodgett was an employee. However, they argued Blodgett had to transfer funds to the corporation to keep the corporation operating. The funds transferred were treated as loans on Glass Blocks Unlimited's books and, as such, a majority of the payments represented nontaxable repayments of the loans.

Based on the following four factors, the court found that the transfers to the corporation were not bona fide loans but capital contributions instead:

- There was no written agreement or promissory note as evidence of the loan.
- The shareholder did not charge interest.
- The corporation did not provide security for the loan.
- There was no fixed payment schedule.

Since the transfers were not bona fide loans, the court found it appropriate to treat the cash payments as distributions instead of loan repayments. Blodgett was the only employee and worked more than 2,080 hours per year. Based on the corporation's determined hourly rate, Blodgett's reasonable compensation exceeded the amount the corporation actually paid him. Since the IRS could only treat the amount actually paid as reasonable compensation, the court determined the entire amount of distributions should be reclassified as wages.

Payroll taxes and penalties

If an S corporation shareholder received payments of cash or property from an S corporation during the year but did not receive any wages for services provided to the corporation, the corporation should determine a reasonable salary for the year based on the facts and circumstances. Then, it should correct the mistake by filing Form W-2 and the applicable payroll tax return(s) (e.g. Form 941, *Employer's Quarterly Federal Tax Return*) for such year, even if filed late.

The tax consequences could be more significant if the IRS reclassifies distributions, loans or similar payments from the S corporation to the shareholder as wages. For example, the corporation is subject to payroll taxes on the wages, but it could also be subject to the failure to file penalty under §6651(a)(1) and the failure to deposit penalty under §6656(b)(1) if it did not file any payroll tax returns. In addition, the 20% negligence penalty under §6662(c) could be assessed.

Case study

In 2025, A&A, Inc. made a late S election with an effective date of Sept. 15, 2024 (date corporation’s first tax year began). The business started in October 2024, but the sole shareholder, Aaron, did not receive any compensation for substantial services provided to A&A during 2024. Instead, he used S corporation funds to pay for his personal living expenses in the amount of \$2,000. Is this a problem?

Yes. In general, the amount the S corporation paid for Aaron’s personal living expenses is treated as a distribution to Aaron. However, all or some of this distribution must be treated as wages since Aaron did not receive any compensation for services provided to A&A.

The corporation needs to determine reasonable compensation for Aaron using the previously mentioned factors. However, reasonable compensation cannot exceed the amount Aaron received, directly or indirectly. Thus, Aaron’s wages cannot be more than \$2,000 for 2024.

After the corporation establishes how much of the distribution to treat as wages, it must file a 2024 Form W-2 and the applicable payroll tax return and deposit the employment taxes as soon as possible to minimize any penalties.

Reporting Requirements

In general, report compensation paid during the year to all officers on Form 1120-S, Line 7, unless deducted elsewhere (e.g., cost of goods sold). The corporation determines which employees to treat as officers under the laws of the state where it is incorporated.

7	Compensation of officers (see instructions—attach Form 1125-E)	7
8	Salaries and wages (less employment credits)	8

Also, complete Form 1125-E, *Compensation of Officers*, and attach it to Form 1120-S if the S corporation has total receipts of \$500,000 or more and deducts compensation for officers. The amount on Form 1125-E, Line 4, equals the amount on Form 1120-S, Line 7.

Total receipts for this purpose equals the sum of the following:

- Form 1120-S, Page 1, Line 1a plus Lines 4 and 5
- Income reported on Schedule K, Lines 3a, 4, 5a and 6
- Income or net gain reported on Schedule K, Lines 7, 8a, 9 and 10
- Income or net gain reported on Form 8825, Lines 2, 19 and 20a

Reasonable Compensation for Shareholders • 19

More-than-2% shareholders

Certain fringe benefits are taxable for employees owning (directly or indirectly) more than 2% of the S corporation stock (i.e., more-than-2% shareholders).

A more-than-2% shareholder-employee for fringe benefit purposes, includes both the actual shareholder and any family members treated as shareholders under the family attribution rules [§§318(a)(1) and 1372(b)]. Treat an individual as if they own stock owned (directly or indirectly) by or for their spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), children (including legally adopted children), grandchildren and parents.

Example

Randy (100% shareholder of an S corporation) hires his son, Ryan, as an employee of the S corporation. Treat Ryan as if he owns 100% of the S corporation stock under the family attribution rules. Thus, Ryan is treated as a more-than-2% shareholder for purposes of determining which fringe benefits are taxable to him.

Taxable fringe benefits for more-than-2% shareholders include all the following:

- Employer contributions to accident and health plans (§§105 and 106)
- Employer contributions to health savings accounts (HSAs) (§223 and Notice 2005-8)
- Cost of up to \$50,000 of group term life insurance (§79)
- Meals and lodging furnished for the convenience of the employer (§119)
- Qualified transportation fringe benefits including parking and transit passes [§132(f)(5)]
- Employee achievement awards [§74(c)]
- Personal use of employer-provided property or services [Reg. §1.61-21(a)]
- Adoption assistance programs (§137)
- Qualified moving expense reimbursements for a member of the Armed Forces of the U.S. on active duty who moves pursuant to a military order and incident to a permanent change of station [§132(g)]

Add these taxable fringe benefits to the shareholder-employee's wages on Form W-2 and deduct them on Line 7. In general, these benefits are subject to FICA and FITW unless an exception applies.

Health insurance

Health insurance premiums paid on behalf of a more-than-2% shareholder/employee (including that shareholder's spouse, dependents and any children under age 27 who are not dependents) must be included in the shareholder's wages (Rev. Rul. 91-26). However, these premiums are not subject to Social Security and Medicare (FICA) taxes if paid under a plan for employees and their dependents (Ann. 92-16). The S corporation deducts these premiums as compensation on Line 7.

Note: Include these premiums on the shareholder's Form W-2, Box 1. However, exclude the premiums from Boxes 3 and 5 since they are not subject to FICA taxes.

Also, report these premiums on Form W-2, Box 14, as an information item, so the shareholder can determine their self-employed health insurance deduction on Form 7206, *Self-Employed Health Insurance Deduction*.

In general, shareholders may deduct up to 100% of the premiums paid as a self-employed health insurance deduction on Schedule 1 (Form 1040), *Additional Income and Adjustments to Income*, Line 17. However, the self-employed health insurance deduction has two limitations:

- The deduction cannot exceed the shareholder's earned income. For this purpose, earned income equals FICA wages paid by the S corporation [§401(c)]. Thus, earned income does **not** include either of the following:
 - S corporation pass-through income reported on Schedule K-1
 - Health insurance premiums included in the shareholder's wages but not subject to FICA taxes
- The deduction is **not** allowed for months the shareholder is eligible to participate in another employer-subsidized health insurance plan, including a plan offered by their spouse's employer. However, §162(l)(2)(B)(i) allows the shareholder to deduct long-term care insurance premiums if not provided under the other employer's plan.

In addition, the plan providing medical care coverage must be established by the S corporation. Insurance laws in some states do not allow a corporation to buy group health insurance when the corporation only has one employee. Consequently, if the shareholder is the only employee of the corporation, the shareholder must purchase the health insurance in their own name. This generally means the plan was not established by the S corporation. However, the IRS provided some relief in this situation. Under Notice 2008-1, shareholders may consider the plan to be established by the S corporation if the S corporation:

- Directly makes the premium payments on the shareholder's policy and reports them on the shareholder's Form W-2 as wages
- Reimburses the shareholder for the premiums the shareholder paid on their own policy and reports the reimbursed premiums on the shareholder's Form W-2 as wages

Note: Notice 2013-54 provides that an employer cannot reimburse **two or more** employees for individual health insurance premiums without violating the market reforms for group health plans. This **employer payment plan** violates the annual dollar limit prohibition because the IRS and the Department of Labor consider it to impose an annual limit up to the cost of the individual coverage. In this case, the employer is subject to an excise tax under §4980D of \$100 per day, per employee, which is reported in Part II of Form 8928, *Return of Certain Excise Taxes Under Chapter 43 of the Internal Revenue Code*, Part II.

However, Notice 2015-17 provides relief from this excise tax for more-than-2% S corporation shareholder-employee healthcare arrangements. Employers eligible for this relief do not have to file Form 8928.

If an S corporation shareholder obtains health insurance in their own name and pays the premiums themselves but is not reimbursed by the S corporation, the S corporation does **not** include the premiums in the shareholder's wages. In addition, the shareholder **cannot** claim the self-employed health insurance deduction because the S corporation did not establish the plan pursuant to Notice 2008-1. However, if the shareholder itemizes deductions, they can deduct the premiums on Schedule A (Form 1040), *Itemized Deductions*.

Example

John, Timothy and Simon are the only shareholder-officers of Big Money Enterprises, Inc., an S corporation. John owns 90% and Timothy and Simon each own 5%. The S corporation has a health insurance plan that covers all three shareholder-employees.

The S corporation paid \$9,000 in health insurance premiums for John, \$7,500 for Timothy and \$6,500 for Simon. John's salary for the year was \$75,000, and Timothy and Simon each received \$55,000.

The S corporation must include each shareholder's health insurance premiums in wages since each of them is a more-than-2% shareholder. Report \$208,000 (\$75,000 + 55,000 + 55,000 + 9,000 + 7,500 + 6,500) on Form 1120-S, Line 7, as follows:

7 Compensation of officers (see instructions—attach Form 1125-E)	7	208,000
8 Salaries and wages (less employment credits)	8	

Include each shareholder's health insurance premiums in wages on Form W-2, Box 1, but exclude them from Boxes 3 and 5. Also, report the health insurance premiums in Box 14. For example, complete John's Form W-2 as follows:

a Employee's social security number xxx-xx-1111		Safe, accurate, FAST! Use		OMB No. 1545-0008		 Visit the IRS website at www.irs.gov/efile	
b Employer identification number (EIN) xx-xxxx333				1 Wages, tips, other compensation 84,000		2 Federal income tax withheld 10,000	
c Employer's name, address, and ZIP code Big Money Enterprises, Inc. 123 Main St Anywhere, MO 55555				3 Social security wages 75,000		4 Social security tax withheld 4,650	
				5 Medicare wages and tips 75,000		6 Medicare tax withheld 1,087.50	
				7 Social security tips		8 Allocated tips	
d Control number				9		10 Dependent care benefits	
e Employee's first name and initial Last name Suff. John Smith 555 Cherry Court Anywhere, MO 55555				11 Nonqualified plans		12a See instructions for box 12	
				13 Statutory employee Retirement plan Third-party sick pay ☐ ☐ ☐		12b	
				14 Other Health ins 9,000		12c	
						12d	
f Employee's address and ZIP code							
15 State Employer's state ID number MO 55555555555555555555555555555555		16 State wages, tips, etc. 84,000		17 State income tax 4,275		18 Local wages, tips, etc.	
						19 Local income tax	
						20 Locality name	

Form **W-2** Wage and Tax Statement
Copy B—To Be Filed With Employee's FEDERAL Tax Return.
 This information is being furnished to the Internal Revenue Service.

2024

Department of the Treasury—Internal Revenue Service

John may claim the self-employed health insurance deduction, assuming he meets all the requirements under §162(l). To determine the amount of his deduction, John completes Form 7206 as shown below. The business income limit on Line 11 is \$75,000 (FICA wages reported on Form W-2, Boxes 3 and 5).

Form 7206		OMB No. 1545-0074	
Department of the Treasury Internal Revenue Service		Attachment Sequence No. 206	
Self-Employed Health Insurance Deduction			
Attach to Form 1040, 1040-SR, or 1040-NR. Go to www.irs.gov/Form7206 for instructions and the latest information.			
Name(s) shown on return John Smith		Your taxpayer identification number ***-**-1111	
Note: Use a separate Form 7206 for each trade or business under which an insurance plan is established.			
1 Enter the total amount paid in 2024 for health insurance coverage established under your business (or the S corporation in which you were a more-than-2% shareholder) for 2024 for you, your spouse, and your dependents. But don't include the following. See instructions. • Amounts for any month you were eligible to participate in a health plan subsidized by your employer or your spouse's employer or the employer of either your dependent or your child who was under the age of 27 at the end of 2024. • Any amounts paid, not to exceed \$3,000, from retirement plan distributions that were nontaxable because you are a retired public safety officer. See instructions. • Any payments for qualified long-term care insurance (see line 2).		1	9,000
2 For coverage under a qualified long-term care insurance contract, enter for each person covered the smaller of (a) or (b). (a) Total payments made for that person during the year. (b) The amount shown below. Use the person's age at the end of the tax year. \$470 — if that person is age 40 or younger \$880 — if age 41 to 50 \$1760 — if age 51 to 60 \$4710 — if age 61 to 70 \$5880 — if age 71 or older Note: The amount of long-term care premiums that can be included as a medical expense is limited by the person's age. Don't include payments for any month you were eligible to participate in a long-term care insurance plan subsidized by your employer or your spouse's employer, or the employer of either your dependent or your child who was under the age of 27 at the end of 2024. If more than one person is covered, figure separately the amount to enter for each person. Then enter the total of those amounts.		2	
3 Add lines 1 and 2		3	9,000
4 Enter your net profit* and any other earned income** from the trade or business under which the insurance plan is established. Don't include Conservation Reserve Program payments exempt from self-employment tax. If the business is an S corporation, skip to line 11		4	
5 Enter the total of all net profits* from Schedule C (Form 1040), line 31; Schedule F (Form 1040), line 34; or Schedule K-1 (Form 1065), box 14, code A, plus any other income allocable to the profitable businesses. Don't include Conservation Reserve Program payments exempt from self-employment tax. See the Instructions for Schedule SE (Form 1040). Don't include any net losses shown on these schedules		5	
6 Divide line 4 by line 5		6	
7 Multiply Schedule 1 (Form 1040), line 15, deductible part of self-employment tax, by the percentage on line 6		7	
8 Subtract line 7 from line 4		8	
9 Enter the amount, if any, from Schedule 1 (Form 1040), line 16, self-employed SEP, SIMPLE, and qualified plans, attributable to the same trade or business in which the insurance plan is established		9	
10 Subtract line 9 from line 8		10	
11 Enter your Medicare wages (box 5 of Form W-2) from an S corporation in which you are a more-than-2% shareholder and in which the insurance plan is established		11	75,000
12 Enter any amount from Form 2555, line 45, attributable to the amount entered on line 4 or 11 above		12	
13 Subtract line 12 from line 10 or 11, whichever applies		13	75,000
14 Self-employed health insurance deduction. Enter the smaller of line 3 or line 13 here and on Schedule 1 (Form 1040), line 17. Don't include this amount when figuring any medical expense deduction on Schedule A (Form 1040)		14	9,000
* If you used either optional method to figure your net earnings from self-employment from any business, don't enter your net profit from the business. Instead, enter the amount attributable to that business from Schedule SE (Form 1040), Part I, line 4b. **Earned income includes net earnings and gains from the sale, transfer, or licensing of property you created. However, it doesn't include capital gain income.			
For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.			
Form 7206 (2024)			

John's self-employed health insurance deduction is \$9,000 as shown above on Line 14. John reports this amount as an adjustment to income on Schedule 1, Line 17, as shown below.

John Smith

***-**-1111

Schedule 1 (Form 1040) 2024

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11	Educator expenses	11	
12	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	12	
13	Health savings account deduction. Attach Form 8889	13	
14	Moving expenses for members of the Armed Forces. Attach Form 3903	14	
15	Deductible part of self-employment tax. Attach Schedule SE	15	
16	Self-employed SEP, SIMPLE, and qualified plans	16	
17	Self-employed health insurance deduction	17	9,000
18	Penalty on early withdrawal of savings	18	
19a	Alimony paid	19a	
b	Recipient's SSN		
c	Date of original divorce or separation agreement (see instructions):		
20	IRA deduction	20	
21	Student loan interest deduction	21	
22	Reserved for future use	22	
23	Archer MSA deduction	23	
24	Other adjustments:		
a	Jury duty pay (see instructions)	24a	
b	Deductible expenses related to income reported on line 8l from the rental of personal property engaged in for profit	24b	
c	Nontaxable amount of the value of Olympic and Paralympic medals and USOC prize money reported on line 8m	24c	
d	Reforestation amortization and expenses	24d	
e	Repayment of supplemental unemployment benefits under the Trade Act of 1974	24e	
f	Contributions to section 501(c)(18)(D) pension plans	24f	
g	Contributions by certain chaplains to section 403(b) plans	24g	
h	Attorney fees and court costs for actions involving certain unlawful discrimination claims (see instructions)	24h	
i	Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations	24i	
j	Housing deduction from Form 2555	24j	
k	Excess deductions of section 67(e) expenses from Schedule K-1 (Form 1041)	24k	
z	Other adjustments. List type and amount:	24z	
25	Total other adjustments. Add lines 24a through 24z	25	
26	Add lines 11 through 23 and 25. These are your adjustments to income . Enter here and on Form 1040, 1040-SR, or 1040-NR, line 10	26	9,000

Schedule 1 (Form 1040) 2024

Reasonable Compensation for Shareholders

review questions

1. _____ Which of the following is taken into consideration when reviewing reasonable compensation for a 10% S corporation shareholder-employee?
 - A. Distributions of cash and property
 - B. Retirement plan contributions
 - C. Shareholder's health insurance premiums
 - D. All the above

2. _____ To establish reasonable compensation for an S corporation shareholder, Reg. §1.162-7(b)(3) analyzes which of the following:
 - A. Amount ordinarily paid for like services by like enterprises under like circumstances
 - B. Distributions made to the shareholder
 - C. What the shareholder-employee did for the S corporation by looking at the source of the S corporation's gross receipts
 - D. Whether the shareholder guaranteed the S corporation's debt

3. _____ Which of the following may be recharacterized as wages if S corporation shareholders do not receive reasonable compensation for services they provided to the S corporation?
 - A. Dividends
 - B. Distributions
 - C. Loan payments
 - D. All the above

Reasonable Compensation for Shareholders

review answers

1.

- A. Incorrect. Answer A is correct, but answers B and C are also correct. According to the IRS, reasonable compensation cannot exceed the amount received by the shareholder either directly or indirectly. Thus, distributions of cash and property are considered when reviewing reasonable compensation.
- B. Incorrect. Answer B is correct, but answers A and C are also correct. Consider the shareholder's total compensation, including retirement plan contributions, when reviewing reasonable compensation.
- C. Incorrect. Answer C is correct, but answers A and B are also correct. Consider the shareholder's total compensation, including taxable fringe benefits like health insurance premiums for more-than-2% shareholders, when reviewing reasonable compensation.
- D. **Correct.** Answers A, B and C are all correct.

[Reasonable compensation]

2.

- A. **Correct.** Reg. §1.162-7(b)(3) describes reasonable compensation as the amount ordinarily paid for like services by like enterprises under like circumstances.
- B. Incorrect. Reg. §1.162-7(b)(3) does not consider distributions or other payments made to the shareholder.
- C. Incorrect. IRS guidance, not Reg. §1.162-7(b)(3), says the key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation by looking at the source of the S corporation's gross receipts.
- D. Incorrect. Whether the shareholder guaranteed S corporation debt is one factor the court analyzed to determine reasonable compensation, but Reg. §1.162-7(b)(3) does not take it into account.

[Reasonable compensation]

3.

- A. Incorrect. Answer A is correct, but answers B and C are also correct. The IRS may recharacterize dividends as wages.
- B. Incorrect. Answer B is correct, but answers A and C are also correct. The IRS may recharacterize distributions as wages.
- C. Incorrect. Answer C is correct, but answers A and B are also correct. The IRS may recharacterize loan payments as wages.
- D. **Correct.** Answers A, B and C are all correct.

[Payments recharacterized]

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