

Reasonable Compensation as an Annual Planning Process

A facts-and-circumstances framework for treating shareholder-employee compensation as a recurring professional judgment - not a one-time number.

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CENTRAL IDEA

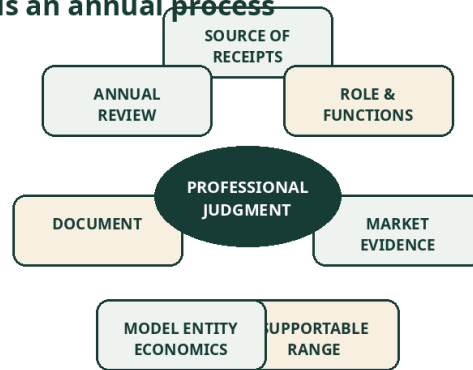
Reasonable compensation should be an annual documented process, not a one-time calculator output.

Educational and practitioner-use material. Verify current authority, deadlines, and taxpayer-specific facts before relying on any strategy.

WHAT THIS PAPER EXAMINES

A facts-and-circumstances framework for treating shareholder-employee compensation as a recurring professional judgment - not a one-time number.

Reasonable compensation is an annual process



“Reasonable compensation should be an annual documented process, not a one-time calculator output.”

Executive perspective

The reasonable-compensation issue is often introduced as a compliance problem: shareholder-employees cannot avoid employment taxes by taking distributions instead of wages. That is correct, but incomplete. Compensation is also a planning variable that affects the economics of the S corporation strategy, retirement-plan contributions, payroll taxes, benefits, financing, cash flow, and the defensibility of the file.

The IRS states that S corporations must pay reasonable compensation to shareholder-employees for services before making non-wage distributions attributable to those services. It also identifies factors such as training and experience, duties, time and effort, dividend history, payments to non-shareholder employees, comparable compensation, agreements, and compensation formulas. Courts have repeatedly permitted the government to reclassify purported distributions or other payments as wages when the facts support wage treatment.

The practical implication is straightforward: reasonable compensation should be an annual documented process, not a one-time calculator output.

Start with the source of gross receipts

The IRS frames the analysis around where the corporation's gross receipts come from: the shareholder's personal services, the services of non-shareholder employees, or capital and equipment. This is particularly important in professional and service businesses. If most revenue is generated directly by the shareholder's labor, the compensation analysis will look very different from a business where employees, inventory, intellectual property, machinery, or invested capital produce a large share of the value.

This is why a simple percentage of profit is conceptually weak. Two corporations can each earn \$300,000 but require very different compensation conclusions. One may be a solo consultant whose personal efforts

generate nearly all revenue; the other may own equipment and employ a team that produces most of the income while the shareholder spends limited time on oversight.

Build a function-based role profile

A useful reasonable-compensation analysis begins with the shareholder's actual functions, not merely a job title. Break the role into the work actually performed. Depending on the business, that may include:

Then document time, responsibility, skill level, credentials, geography, staffing, and the extent to which each function contributes to revenue. A blended role may justify a blended compensation analysis rather than forcing the shareholder into a single occupation code.

- technical or professional service delivery
- sales and business development
- management and supervision
- administration and bookkeeping oversight
- marketing and client relationship management
- production or operations
- compliance and quality control
- strategic leadership
- capital management and financing.

Use market evidence as evidence, not as an answer

External compensation data can be valuable, but it should be reconciled to the shareholder's actual duties. A generic salary survey may assume a 40-hour employee role, benefits, a particular labor market, no ownership responsibility, and none of the entrepreneurial risk or administrative functions present in the actual business.

A stronger file records the source and date of the market data, the occupation or functions selected, geographic adjustments, hours or full-time-equivalent assumptions, and any modifications made for the facts. The goal is not false precision. The goal is an explainable range grounded in evidence.

Reasonable compensation is usually a range

Tax planning often becomes distorted when a facts-and-circumstances determination is expressed as if there were one mathematically correct salary. In many cases, the available evidence supports a range. The practitioner can then select a position within that range based on the documented facts and monitor whether the facts change.

A range also makes the analysis more honest when the shareholder performs multiple roles or when market data are imperfect. It allows the practitioner to distinguish between a supportable zone and a tax-motivated outlier.

“The goal is not false precision. The goal is an explainable range grounded in evidence.”

Annual review matters because the facts change

ANNUAL REVIEW LENS

- Hours and duties
- Revenue composition
- Staffing and outsourced functions

- Profitability
- Distributions and bonuses
- Market compensation evidence
- Retirement-plan objectives
- Benefit treatment
- Material changes in business structure

The compensation conclusion can change even when ownership does not. The shareholder may work fewer hours, hire a manager, stop performing production work, add employees, sell a division, acquire equipment, move to a new labor market, reduce client-facing work, or transition toward retirement. Conversely, the shareholder may become more involved, assume work previously done by staff, or personally drive a larger percentage of revenue.

An annual review should therefore compare the current year with the prior year:

- hours and duties
- revenue composition
- staffing and outsourced functions
- profitability
- distributions and bonuses
- market compensation evidence
- retirement-plan objectives
- benefit treatment
- material changes in business structure.

Compensation affects whether the S corporation strategy works

BETTER QUESTION

Does the S corporation still produce a meaningful Net Economic Benefit when compensation is modeled at a defensible level?

An S corporation analysis that assumes an artificially low salary can manufacture a tax savings that disappears under a supportable compensation level. For that reason, compensation should not be analyzed after the entity decision. It should be part of the entity decision.

The comparison should incorporate employer and employee payroll taxes, payroll-service cost, state payroll obligations, unemployment taxes, retirement-plan effects, shareholder health-insurance treatment, QBI interactions where relevant, and recurring administrative costs. The proper question is not “How low can salary be?” It is “Does the S corporation still produce a meaningful Net Economic Benefit when compensation is modeled at a defensible level?”

Retirement-plan interaction

Compensation can directly affect contribution capacity in employer retirement plans. Lower wages may reduce employer contribution amounts or otherwise change plan economics. A practitioner who models payroll taxes without modeling the retirement plan may recommend a compensation level that is tax-efficient in one column but inconsistent with the owner's retirement objective.

The same issue arises when a business owner is approaching retirement, adding employees, changing plan design, or considering a cash balance or other qualified plan. Reasonable compensation remains a tax requirement; retirement-plan design cannot simply dictate a wage number unsupported by the shareholder's services.

Distributions, loans, personal expenses, and other payment forms

Changing the label on a payment does not necessarily change its employment-tax character. The IRS and courts have addressed distributions, purported loans, personal expenses, and other payments when shareholder-employees performed substantial services. The analysis should therefore consider the total economic relationship between the shareholder and corporation rather than focusing only on the W-2 line.

If the corporation is distributing substantial cash while reporting little or no officer compensation, that is a clear review trigger. So is a pattern in which year-end distributions are large while wages remain unchanged despite material increases in the shareholder's work or revenue production.

Worked example

Assume a sole shareholder owns a consulting S corporation with \$360,000 of gross receipts and \$230,000 of income before shareholder wages and payroll taxes. The shareholder personally performs client consulting, sells new engagements, supervises one administrative employee, and handles strategic management. The shareholder works approximately 1,900 hours annually.

A simplistic analysis might select a \$60,000 salary because it produces attractive payroll-tax savings. A function-based analysis instead identifies several roles: senior consultant, sales/business development, and management. Market data are gathered for each function, adjusted for geography and time allocation, and support a blended annual range of approximately \$125,000 to \$155,000 under the assumed facts.

The practitioner then models the S corporation economics across that range rather than at \$60,000. If the entity still provides a worthwhile net benefit after payroll taxes, plan effects, administrative cost, and state consequences, the strategy remains viable. If it does not, the correct conclusion may be to retain the current structure. The compensation analysis therefore serves both compliance and planning.

Documentation file

A practical annual workpaper can be concise if it is structured. It should generally include:

- shareholder ownership and officer status
- description of the business and source of gross receipts
- functions performed and estimated time allocation
- training, credentials, experience, and responsibilities
- non-shareholder employee roles and compensation
- market compensation sources and dates
- adjustments and assumptions
- supportable range and selected compensation
- distributions and other payments to the shareholder
- retirement-plan and benefit interactions
- changes from the prior-year analysis
- next review date.

Common failure modes

WHAT PRACTITIONERS OFTEN MISS

- A fixed percentage of profit is not a substitute for actual services.
- Last year's wage is not automatically this year's answer.
- One occupation code may not fit a multi-function owner.
- Retirement and benefit consequences belong in the analysis.
- Contemporaneous support is stronger than reconstruction years later.

- Using a fixed percentage of profit. Profit is relevant context, but a percentage is not a substitute for the shareholder's actual services.
- Carrying last year's wage forward automatically. Business facts change.
- Choosing salary solely to maximize payroll-tax savings. That reverses the proper analysis.
- Using one occupation code for a multi-function owner. A blended role may require a blended analysis.
- Ignoring distributions and non-W-2 payments. Payment labels do not control substance.
- Ignoring retirement and benefit consequences. Compensation affects more than employment tax.
- Failing to preserve contemporaneous support. Reconstructing the rationale years later is weaker than documenting it when the decision is made.

What the cases teach without creating a formula

The reasonable-compensation cases are useful less because they provide a universal number than because they reinforce recurring principles. Courts have looked past labels when a shareholder performs substantial services and receives economic value from the corporation. The IRS specifically cites cases such as *Veterinary Surgical Consultants*, *Joseph M. Grey*, *Public Accountant*, and *Watson* when explaining the wage treatment of shareholder-employees. The lesson is that the analysis must fit the actual services and payment pattern.

Watson is often reduced in practitioner conversation to a salary benchmark. That is a mistake. A judicial result from one accounting practice with one set of facts is not a safe harbor for unrelated businesses. The useful lesson is that a court can compare reported wages with the value of the shareholder's services and reject a deliberately low wage when the surrounding facts make that wage implausible.

Part-year, startup, and changing-role situations

Annual salary surveys assume a full period, but real businesses often do not. A shareholder may form the corporation midyear, begin payroll after an election becomes effective, take an extended leave, reduce hours, or transition responsibilities to staff. The workpaper should therefore distinguish annualized market compensation from compensation for the actual service period.

Similarly, startup years may have limited cash. Cash constraints are relevant facts, but they do not automatically eliminate the wage issue when the shareholder is receiving distributions or other economic benefits. Document the corporation's ability to pay, payment timing, accrued compensation where relevant, and the relationship between wages and other shareholder transfers.

Financing and underwriting considerations

Compensation changes can affect more than tax. A business owner planning a mortgage or other financing may discover that an abrupt shift from Schedule C income to W-2 wages and S corporation distributions changes how an underwriter views the income history. That does not dictate the tax result, but it can affect timing and implementation.

A complete entity and compensation analysis should therefore ask whether major financing is expected in the next one or two years and whether the lender or underwriter has documentation requirements that should be coordinated before the business structure changes.

Compensation changes should produce a change log

When the selected wage changes materially from the prior year, the file should say why. The explanation may be increased hours, new staff, different service mix, a changed geography, a new line of business, a reduction in production work, or updated market evidence. A concise change log can be more valuable than recreating a long memorandum every year because it shows continuity and contemporaneous reasoning.

Practice takeaway

Reasonable compensation is best viewed as an annual professional-judgment process embedded inside the broader S corporation planning cycle. The objective is not the lowest defensible wage or the highest survey number. It is a supportable compensation conclusion that reflects the shareholder's actual work and remains economically coherent with the rest of the plan.

Primary references and further reading

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- IRS: S corporation compensation and medical insurance issues
- IRS: S corporation employees, shareholders and corporate officers
- IRS Instructions for Form 1120-S
- IRS: Paying yourself

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