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Avoid Trouble: Don't Let the IRS Set Your S Corporation Salary

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You likely formed an S corporation to save on self-employment taxes.

If so, is your S corporation salary

- nonexistent?
- too low?
- too high?
- just right?

Getting the S corporation salary right is important. First, if it's too low and you get caught by the IRS, you will pay not only income taxes and self-employment taxes on the too-low amount, but also both payroll and income tax penalties that can cost plenty.

Second, in most cases, the IRS is going to expand the audit to cover three years and then add the income and penalties for those three years.

Third, after being found out, you likely are now stuck with this higher salary, defeating your original purpose of saving on self-employment taxes.

Getting to the Number

The IRS did you a big favor when it released its "Reasonable Compensation Job Aid for IRS Valuation Professionals."

The IRS states that the job aid is not an official IRS position and that it does not represent official authority. That said, the document is a huge help because it gives you some clearly defined valuation rules of the road to follow and takes away some of the gray areas.

Market Approach

The market approach to reasonable compensation compares the S corporation's business with others and then looks at the compensation being paid by those businesses to employees who look like you, the shareholder-employee who is likely the CEO.

The question to be answered is, how much compensation would be paid for this same position, held by a nonowner in an arm's-length employment relationship, at a similar company?

In its job aid, the IRS states that the courts favor the market approach, but because of challenges in matching employees at comparable companies, the IRS developed other approaches.

Cost Approach

The cost approach breaks your employee activities into their components, such as management, accounting, finance, marketing, advertising, engineering, purchasing, janitorial, bookkeeping, clerking, etc.

Here's an example of how the cost approach works to support a $71,019 salary as reasonable compensation for this S corporation owner whose corporation had $3.5 million in revenue and 19 employees:

Task	Hours	Wage	Amount
Taxi driver and chauffeur	104	$12.75	$1,326
General manager	624	$58.32	$36,392
Wholesale buyer	166	$27.59	$4,575
Collections clerk	146	$15.32	$2,237
Sales representative	624	$30.96	$19,149
Order clerk	416	$18.56	$7,340
Totals	2,080	N/A	$71,019

Health Insurance

The S corporation's payment or reimbursement of health insurance for the shareholder-employee and his or her family goes on the shareholder-employee's W-2 and counts as compensation, but it's not subject to payroll taxes, so it fits nicely into the payroll tax savings strategy for the S corporation owner.

Pension

The S corporation's employer contributions on behalf of the owner-employee to a defined benefit plan, simplified employee pension (SEP) plan, or 401(k) count as compensation but don't trigger payroll taxes. Such contributions further enable the savings on payroll taxes while adding to the dollar amount that's considered reasonable compensation.

Planning note. Your S corporation compensation determines the amount that your S corporation can contribute to your SEP or 401(k) retirement plan. The defined benefit plan likely allows the corporation to make a larger contribution on your behalf.

Section 199A Deduction

The S corporation's net income that is passed through to you, the shareholder, can qualify for the 20 percent Section 199A tax deduction on your Form 1040.

If you would like my help with planning your S corporation salary, please call me at 770-978-9565, or send an email to LWalker@4-serenity.com.

Sincerely,

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