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Reasonable Compensation to a Shareholder-Employee of an S-Corporation

S Corporations must pay reasonable compensation to a shareholder-employee in return for services that the employee provides to the corporation before non-wage distributions may be made to the shareholder-employee. The amount of reasonable compensation will never exceed the amount received by the shareholder either directly or indirectly.

Under the Internal Revenue Code, the IRS has the authority to reclassify payments made to the officer/shareholder from non-wage distributions (which are not subject to employment taxes) to wages (which are subject to employment taxes). Several court cases support the authority of the IRS to reclassify other distributions to a shareholder/officer/employee as a wage expense which are subject to employment taxes.

The key to establishing reasonable compensation is determining what the shareholder/officer/employee did for the S Corporation by looking to the source of the S corporation's gross receipts.

The three major sources are:

1.) Services of shareholder/officer
2.) Services of non-shareholder employees
3.) Capital and equipment

To the extent gross receipts are generated by services of non-shareholder employees, payments to the shareholder/officer would properly be treated as non-wage distributions that are not subject to employment taxes.

But to the extent gross receipts are generated by the shareholder's/officer's personal services, then payments to the shareholder-employee should be classified as wages that are subject to employment taxes.

In addition to gross receipts generated directly by the shareholder/officer/employee, the shareholder/officer/employee should also be subject to wage treatment for administrative work performed by him for the other income-producing employees or assets. For example, a manager may not directly produce gross receipts, but he assists the other employees or assets which are producing the day-to-day gross receipts.

Some factors 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
- The use of a formula to determine compensation