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Reasonable Compensation for S Corporation Owners

The Number the IRS Litigates — and the Documentation That Wins

Scenario: An S corporation owner wants to minimize FICA by paying a low salary and taking most profit as distributions, and needs to know exactly how low is defensible and what happens if the figure is challenged.

Executive Summary

Reasonable compensation is the most litigated feature of the S corporation. The obligation flows from §3121(d)(1), which treats an officer who performs more than minor services as an employee, and from a line of authority — anchored by *Radtke, Watson*, and Rev. Rul. 74-44 — permitting the IRS to recharacterize distributions as wages when the salary is unreasonably low. The consequence is retroactive FICA, failure-to-deposit penalties under §6656, and interest. The objective is not the lowest number — it is the lowest *defensible* number, and defensibility is a documentation problem before it is a valuation problem.

Key point

Zero-salary or token-salary structures are the classic audit trigger. In *Watson v. United States*, a \$24,000 salary against roughly \$200,000 in distributions was reset to a \$91,000 reasonable wage — the court did not accept the low figure, and the recharacterization carried employment tax on the difference.

The Legal Test and Its Origin

There is no statutory percentage. The standard is what an arm's-length employer would pay for the same services, evaluated on facts and circumstances. Rev. Rul. 74-44 established that distributions substituted for salary can be recharacterized; courts have consistently applied a multi-factor analysis rather than any mechanical formula. A salary set as a fixed fraction of revenue or profit — the "60/40" and "one-third" rules of thumb one hears — is not a defense on its own and has been rejected where it did not reflect the value of services actually rendered.

The Factors Courts Weigh

Factor	What it tests
Training and experience	Qualifications and the skill the role demands
Duties and responsibilities	Actual scope of services to the corporation

Time and effort	Hours devoted; full- versus part-time involvement
Comparable market pay	Wages for similar services in the same market and field
Compensation of non-owner staff	Internal pay relationships
Use of a consistent formula	How the figure was set and whether it was applied consistently
Source of profit: services vs. capital	Profit driven by owner labor supports a higher wage; profit from capital or a leveraged workforce supports a lower one

Building a Number That Survives Examination

A defensible figure begins with market compensation data for the specific role, then adjusts for hours and duties. Credible sources include Bureau of Labor Statistics OES wage data, RCRReports-style analyses, and industry surveys. For physicians and healthcare professionals, MGMA, SullivanCotter, and AMGA benchmarks are the standard references, ideally matched to specialty, region, and productivity. The file should capture the comparable role, the data source and date, the percentile selected, and the reasoning — contemporaneously, not reconstructed after a notice.

The services-versus-capital distinction

Where profit is overwhelmingly attributable to the owner's personal services — a solo consultant, a single-physician practice — a high wage relative to profit is appropriate, and a thin salary is hard to defend. Where meaningful profit derives from employees, equipment, or invested capital, a proportionally lower wage can be justified, because not all profit is a return on the owner's labor. This distinction, properly documented, is often the difference between a defensible position and a recharacterization.

Consequences of Setting It Too Low

- **Recharacterization** of distributions as wages, retroactively across open years.
- **Back employment tax** — both halves of FICA on the reclassified amount.
- **Penalties under §6656** for failure to deposit, plus interest.
- **Collateral corrections** — amended 941s, corrected W-2s, and cascading state payroll filings (DE 9/DE 9C in California).

Interactions That Change the Target

The salary does not live in isolation. It sets the ceiling on retirement-plan contributions (a solo 401(k) employer contribution is a function of W-2 wages; a defined benefit plan can demand a higher salary), and it directly affects the §199A QBI deduction, where wages both reduce QBI and, above the thresholds, support the W-2 wage limitation. The right figure optimizes across payroll tax, retirement funding, and QBI simultaneously — not any one in isolation.

Practical Considerations

Run payroll on a regular cadence, not a single December lump sum, which reads as an afterthought under examination. Keep the benchmarking file current and revisit the figure annually as profit, hours, and duties shift. If a defined benefit or large profit-sharing plan is in play, model the salary against the plan's funding requirement before the first payroll of the year.

Next Step: Benchmark Before the First Payroll

A reasonable-compensation analysis for your profession, hours, and region — with cited comparables and a documented percentile — yields both a defensible figure and the file to support it. It belongs at the start of the year, not in response to a notice.

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