FINANCIAL FOUNDATIONS

An Educational Ebook Series for Small Business Owners

BOOK 16

Reasonable Compensation Non-Compliance

Understand compensation compliance risks before they become costly.

TLC Business Solutions · Expert Bookkeeping & Accounting Services

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BOOK 16 OF 16

Reasonable Compensation & Consequences of Non-Compliance

A compliance guide for S-Corporation owners and small business officers — what the IRS requires, what it costs to get it wrong, and how to prove your pay is right.

TLC Business Solutions

ACCOUNTING · BOOKKEEPING · TAX · PAYROLL

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01 What Is "Reasonable Compensation"?

> *Reasonable compensation is the market-rate salary an S-Corporation owner must pay themselves for the work they actually perform — before a single dollar is taken as a distribution.*

Reasonable compensation is the amount of salary that an S-Corporation shareholder-employee — or a corporate officer who provides services to the business — would receive for their work in a similar enterprise. It is the wage that the open market would pay for the duties, responsibilities, and skills the owner brings to the company. It is **not** a token figure, and it is **not** optional.

The rule exists because of how S-Corporations are taxed. An S-Corp is a pass-through entity: the business's profits flow directly to the owner's personal tax return. Money taken out as a *distribution* (a return on your ownership stake) is **not** subject to Social Security and Medicare taxes. Money paid as *wages* **is**. Without a salary requirement, an owner could label every dollar a "distribution" and lawfully sidestep payroll taxes on tens of thousands of dollars of income. The reasonable-compensation rule closes exactly that loophole.

The mechanics are simple in principle but strict in practice. If you work in your S-Corp, you must pay yourself a salary that reflects the value of that work — run through a real payroll system that withholds Social Security and Medicare, issues a W-2, and files the required payroll tax returns. **Only after that salary is paid can remaining profits be taken as distributions.** Skip the salary, or set it artificially low, and the structure that makes an S-Corp attractive becomes the structure the IRS examines first.

> **THE CORE PRINCIPLE**
>
> If you perform services for your S-Corporation, you are an employee of it — and employees get paid a wage. Distributions reward ownership; they do not replace wages for work performed.

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02 IRS Guidelines: Pay a Market-Rate Salary First

Salary comes first. Distributions are not a substitute for wages — they are a supplement to them.

The IRS is explicit: an S-Corporation that has shareholder-employees performing services must pay those individuals reasonable compensation **before** any non-wage distributions are made. The order is not negotiable. Wages for services rendered come first; distributions from profit come after. An owner cannot elect to "take it all as a distribution this year and catch up on salary later."

What "reasonable" means is equally direct: the amount a similar business would pay for the same kind of work, given the person's role, duties, and the going market rate. There is no single dollar figure, no safe-harbor percentage of revenue, and no line on a tax form that answers the question for you. A $1 salary, or a salary plainly below market with the balance pulled out as distributions, is precisely the pattern the IRS looks for — and it is the pattern that fails review.

Enforcement is not theoretical. TLC Business Solutions' own guidance is blunt on this point: the IRS is **increasing its enforcement efforts** to catch taxpayers who are not in compliance, and the agency **can — and has — reclassified distributions as wages**, resulting in increased taxes, penalties, and interest. The safe posture is to assume your salary figure will be examined, and to have the analysis ready to defend it *before* anyone asks.

The salary-first test, in three questions

- **Does the shareholder perform services?** If yes, a salary is required — full stop.
- **Is the salary at market rate?** "Reasonable" means comparable to what similar businesses pay for similar work.
- **Was the salary paid before distributions?** Distributions layered on top of a real wage are fine; distributions taken *instead of* a wage are the problem.

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03 Consequences of Non-Compliance

> *Getting reasonable compensation wrong is one of the most expensive errors a small business owner can make — because the IRS does not simply ask you to fix it going forward. It recalculates the past.*

When the IRS determines that an S-Corporation has not paid its shareholder-employees reasonable compensation, it does not let the matter rest with a polite notice. It reclassifies the distributions as wages, and that reclassification carries a cascade of costs that compound across every year under examination. The most common consequences are below.

Audit risk

S-Corporations with shareholder-employees who report little or no wages — but large distributions — are a perennial focus of IRS examination. The mismatch between salary and distributions is one of the first things a reviewer keys on, and once an audit opens, the scope tends to widen across the return.

Reclassification of distributions as wages

The IRS reclassifies the distributions as wages retroactively. The owner does not get to keep the payroll-tax savings that made the arrangement attractive in the first place; instead, the reclassified amounts become wages subject to all of the obligations wages carry.

Back payroll taxes — Social Security and Medicare

Because the reclassified dollars are now wages, they trigger the full Social Security (12.4%, up to the annual wage base) and Medicare (2.9%) payroll taxes. As a practical matter, both the employer and employee portions fall on the reclassified owner, so the cumulative burden approaches the full 15.3% self-employment-equivalent cost on the amount reclassified — precisely the tax the structure was meant to avoid.

Penalties and interest

On top of the back taxes, the IRS assesses penalties and interest that accrue from the original due dates. These add up quickly and frequently rival the underlying tax itself — turning a planning shortcut into a multi-year liability.

Multi-year exposure and personal liability

Examinations rarely stop at a single year. A determination that compensation was unreasonable

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typically reopens each open year under review, multiplying the back-tax, penalty, and interest totals. In certain cases, the individuals responsible for collecting and remitting withheld payroll taxes can be held personally liable for the trust-fund portion — meaning the debt can follow the owner personally, beyond the business.

FROM TLC'S PRACTICE
"The IRS can and has reclassified distributions as wages, resulting in increased taxes, penalties, and interest." A documented reasonable-compensation analysis may help an owner respond to an examination; individual outcomes vary. Results from past client engagements. Individual outcomes vary and are not a guarantee of future results.

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04 Factors Used to Determine Reasonable Pay

> *There is no one-size-fits-all number. Reasonable compensation is determined by the specific facts and circumstances of the owner and the business — judged against what the market actually pays.*

The IRS evaluates reasonableness by weighing a defined set of factors rather than applying a flat formula. The goal is to approximate, as honestly as possible, what a similarly situated business would pay an outsider to perform the same work. The factors below are the ones most often weighed in a reasonable-compensation determination.

FACTOR	WHAT IT MEASURES
Training & qualifications	Formal education, licenses, certifications, and specialized training the owner brings to the role.
Experience	Years in the field and in the specific work the owner now performs for the business.
Duties & responsibilities	The scope of the owner's role — operations, sales, management, technical delivery — and how central each is to revenue.
Time & effort	Hours worked and the proportion of the owner's working time devoted to the business.
What similar businesses pay	Comparable salaries for the same position at similar firms — the single most persuasive factor in any review.
Profitability & distribution history	The company's profits and the pattern of dividends/distributions taken alongside the salary.
Ownership & control	The owner's ownership percentage and authority — sole owners face the strictest scrutiny.

Of these, the comparison to **what similar businesses pay for similar work** carries the most weight. Salary surveys, industry compensation data, and documented comparables for the owner's actual duties are the evidence that converts an opinion into a defensible figure. An owner who can show that comparables support the salary chosen is in a fundamentally different posture than one who simply picked a number.

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05Documenting Your Decision: The Reasonable Comp Study

> *The single most effective thing an S-Corp owner can do is not pick the right number — it is prove they picked it deliberately.*

Contemporaneous documentation is what separates a defensible salary from an exposed one. A formal **Reasonable Compensation study** (sometimes called a reasonable-comp analysis or report) captures, at the time the decision is made, the factors above and the market data behind the salary chosen. If the IRS later questions the figure, the owner is not improvising an answer under pressure — they are producing a document that shows the salary was set by method, not by mood.

What a defensible study contains

- **A description of the owner's role and duties** — the actual work performed, not the title on the filing.
- **Comparable compensation data** — salary surveys, industry benchmarks, or documented market rates for similar positions.
- **The methodology applied** — how the comparables were selected and how the figure was derived from them.
- **The concluded salary** — the specific reasonable-compensation amount, supported by the analysis above.

TLC's guidance is direct on the cadence as well: S-Corporations with shareholder-employees should have a **reasonable compensation report prepared annually** for each such person, so there is fresh proof on file that the salaries paid are indeed "reasonable." Circumstances change — revenue, duties, market rates — and a study that was persuasive three years ago may not match today's facts. Treating the analysis as a recurring, dated record is what makes it useful when it is needed most.

HOW TLC HELPS

TLC Business Solutions prepares annual reasonable-compensation reports for S-Corporation shareholder-employees — giving you a contemporaneous, defensible record that the salaries you pay are reasonable, ready to hand to the IRS before you ever have to.

— tlcbusinesssolutions.com / services

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Key Takeaways

CHAPTER 15 · REASONABLE COMPENSATION

01 **Salary comes first.** If you perform services for your S-Corp, you must pay yourself a market-rate wage — through real payroll — before taking any distributions.

02 **Reasonable means market-rate.** There is no flat number or safe-harbor percentage. "Reasonable" is what similar businesses pay for similar work.

03 **Distributions are a supplement, not a substitute.** Layering distributions on top of a real wage is fine; taking them *instead of* a wage is the violation.

04 **The cost of getting it wrong is severe.** The IRS reclassifies distributions as wages, triggering back Social Security/Medicare taxes, penalties, and interest — often across multiple years.

05 **Personal exposure is real.** Multi-year assessments — and, in some cases, personal liability for trust-fund payroll taxes — can follow the owner beyond the business.

06 **Document, every year.** A formal, dated reasonable-compensation study turns an opinion into a defensible record; TLC recommends one annually for each shareholder-employee.

07 **Get professional help.** Reasonable compensation is too consequential — and too fact-specific — to set by guesswork. Work with a firm that can build the analysis and stand behind it.

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Protecting your savings, your salary, and your standing with the IRS.

TLC Business Solutions

Build Your Financial Foundations with TLC

TLC Business Solutions helps small business owners strengthen bookkeeping, accounting, payroll, tax consulting, financial management, and practical decision-making systems so the numbers are clean, useful, and ready for growth.

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