

# Reasonable Compensation for S Corps 2024



*The only company that provides accurate, independent Reasonable Compensation reporting backed by IRS criteria, court rulings, and industry salary intelligence.*

## RCReports Overview

RCReports determines Reasonable Compensation for Closely-Held Business Owners.

RCReports is a tool used by CPA's, EA's, Tax Advisors, Valuers, Forensic Accountants and Attorneys when they need to determine a Reasonable Compensation figure for a client. Whether for Tax Compliance, Normalization or Planning, RCReports has the report and approach to fit your need.

RCReports synthesizes a proprietary blend of IRS criteria, court rulings, geographic data and its **EXCLUSIVE** database of wages to accurately and objectively determine Reasonable Compensation for Closely-Held Business Owners.

All Reasonable Compensation Reports deliver an **Independent Unbiased** Reasonable Compensation figure that can be relied on in IRS examinations and Litigation.

## Key Product Features

- RCReports results are available immediately
- RCReports operates in the cloud: simply login and begin generating reports in minutes
- RCReports offers all three recognized approaches: Cost, Market & Income
- RCReports establishes Reasonable Compensation fully defensible to the IRS & Court
- RCReports have a 30 day edit window
- RCReports are backed by a comprehensive Methodology report

**“We have provided RCReports to IRS auditors without issues or problems when asked as a checklist item on a small business audit.” ~Randy Tarpey, CPA**

# RCReports

Reasonable Compensation Simplified™

## About The Presenters

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**Paul S. Hamann**

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Paul Hamann is an expert on determining Reasonable Compensation for closely-held business owners. He has educated more than 30,000 tax advisors and valuers on the topic of Reasonable Compensation and has been published in numerous state CPA society journals.

Paul, along with other experts in their own fields founded RCReports in 2010. RCReports cloud software determines reasonable compensation for Closely-Held Business Owners and is used by CPA's, EA's, Tax Advisors, Valuers, Forensic Accountants and Attorneys when they need to determine a Reasonable Compensation figure for a client. Whether for Tax Compliance, Normalization or Planning, RCReports has the report and approach to fit your need.

When Paul isn't in the office he enjoys spending time with his wife and two chocolate labs, hiking Colorado's back country or paddling its scenic lakes and rivers.

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**John Morse, PhD, CPA**

**RCReports Educational Ambassador**

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**(303) 297-1660**



John Morse has operated his own CPA firm John P. Morse, CPA, LLC, since 2014, specializing in tax, small business accounting, and campaign compliance. Prior to that he served in the Colorado State Senate, most recently as the President of the Senate. After graduating from college, he worked as a CPA for Fox & Company in Colorado Springs, CO, and then for Deloitte, Haskins & Sells in Denver as an audit manager. So, he has roughly 20 years of CPA experience.

Between the time he left Deloitte and started his own firm he served as a paramedic in Denver, a police officer, detective, and sergeant in Colorado Springs, CO, a police chief in Fountain CO, and the CEO of a nonprofit organization that worked to keep people over age 60 independent, and in their own homes for as long as possible. From there he entered the Colorado State Senate.

Morse received his BSBA with an emphasis in accounting and finance from the University of Colorado. He earned an MBA from Regis University, a master's degree in public administration from the University of Colorado, a master's degree in taxation from Golden Gate University in San Francisco, and a PhD in public administration from the University of Colorado.

# Agenda

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1. Advantage of Distribution V. Wages
2. Reasonable Compensation in the courts
3. IRS Guidelines & Criteria
4. Profitability of an S Corp V. Distribution of an S Corp
5. Reasonable Compensation & the IRS
6. Determining Reasonable Compensation
7. Tips, Advice, Q&A

## 1. Distribution V. Wages

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### 1. Definitions – Interchangeable Terms

- a. Reasonable Compensation = Replacement Cost
- b. Reasonable Compensation = Fair Market Value
- c. Distributions = Dividends
- d. Distributions = Loan repayment, Return of basis
- e. Shareholder-Employee (SE) = Corporate officer
- f. Shareholder-Employee (SE) = S Corp owner

### 2. Example 1:

- a. Scott Stone owns 100% of the stock of an S Corp (Stone Concrete).
- b. Scott works fulltime for Stone Concrete.
- c. Stone Concrete generates \$100,000 of net income before considering Scott's salary.
- d. If Scott draws a \$100,000 salary, Stone Concrete's taxable income will be reduced to zero.
- e. Scott reports \$100,000 of wage income on his 1040
- f. Scott and Stone Concrete are liable for applicable payroll taxes:
  - i. 7.65% Stone Concretes portion of SS/Medicare = \$7,650
  - ii. 7.65% Scott's portion of SS/Medicare = \$7,650
- g. State & Federal unemployment = ???
- h. Tax liability of \$15,300+

3. Example 2: Same assumptions
  - a. Scott Stone owns 100% of the stock of an S Corp (Stone Concrete).
  - b. Scott works fulltime for Stone Concrete.
  - c. Stone Concrete generates \$100,000 of net income before considering Scott's salary.
  - d. Scott withdrawals \$100,000 from Stone Concrete as distribution
  - e. Stone Concretes taxable income will be \$100,000 and will pass through to Scott on his 1120S and be reported on his 1040
  - f. No payroll tax for Stone Concrete
  - g. No self-employment tax on distributions
  - h. Tax Savings \$15,300+
  
4. IRS REQUIREMENT: "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation." ~ [Instructions 1120S](#)
  
5. 199A & QBID:
  - a. Historically S Corps skinned down their reasonable compensation and C Corps fattened up theirs. That has changed with the passage of the TCJA.
  - b. Section 199A & the QBID contains a long list of variables that will affect the QBID and reasonable compensation is one of those variables.
  - c. Because of these variables there are now scenarios where a fat reasonable compensation figure will benefit an S Corp and a skinny reasonable compensation amount will benefit a C Corp
  - d. Optimized V. Reasonable Compensation

## 2. Reasonable Compensation in the Courts

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1. DAVID E. WATSON, P.C., V. UNITED STATES OF AMERICA 2010
  - a. Mr. Watson's firm made profit distributions:
    - i. \$203,651 in 2002
    - ii. \$175,470 in 2003
  - b. Mr. Watson received salary:
    - i. \$24,000 in 2002
    - ii. \$24,000 in 2003
  - c. The IRS objection
    - i. Graduate degree in tax
    - ii. 20 years' experience
    - iii. Worked 35 - 45 hours a week.
  - d. IRS audited Mr. Watson, calculated Reasonable Compensation:
    - i. \$91,044 for 2002
    - ii. \$91,044 for 2003
  - e. Re-characterized \$67,044 of dividends and loan payments as wages for each year = \$134,000
  - f. Total tax, penalty and interest assessed to Mr. Watson was \$48,521
  - g. Mr. Watson took the IRS ruling to court.
    - i. December 2010 the US District Court for the Southern District of Iowa ruled in favor of the IRS.
    - ii. Court findings:
      - a. General accounting
      - b. Partner of his firm
      - c. Business Structure
    - iii. Mr. Watson did NO RESEARCH on his salary figure of \$24,000 and had NO DOCUMENTATION outlining how his salary was reached.
  - h. Appealed and in February of 2012 the US Court of Appeals for the Eighth Circuit upheld the District Courts Ruling.
  - i. Mr. Watson appealed to the US Supreme Court – and that appeal was denied in October 2012

## 2. MCALARY V. COMMISSIONER 2013

- a. McAlary LTD – Real Estate Company
- b. Mr. McAlary worked full time
- c. Zero salary
- d. \$240,00 distribution
- e. IRS calculation of Mr. McAlary's Reasonable Compensation \$100,755:
  - i. Primary job function Real estate broker
  - ii. Full time (12 hour days 6-7 days per week)
  - iii. Compared McAlary LTD to peers
  - iv. \$48.44 per hour x 2080 = 100,755
- f. Mr. McAlary defense of \$24,000 Reasonable Compensation:
  - i. Compensation agreement
  - ii. Board of Directors
  - iii. Built in increases
- g. Court calculation of Mr McAlary Reasonable Compensation \$83,200:
  - i. Various services
  - ii. BLS wage range
  - iii. \$40 per hour x 2080 = 83,200
- h. Determining an employee's reasonable compensation is dependent upon a number of factors and is far from an exact science.

## 3. Court Rulings:

- a. Sean McAlary Ltd, Inc. v. Commissioner 2013
- b. Glass Blocks Unlimited v. Commissioner 2013
- c. Patrick & Suzanne Herbert v. Commissioner 2012
- d. David E. Watson, P.C. v. United States 2010
- e. JD & Associates, LTD v. United States 2006
- f. Joseph M. Grey Public Accountant, P.C. v. Commissioner 2002\*\*
- g. Veterinary Surgical Consultants,P.C. v. Commissioner 2001\*\*
- h. Joly v. Commissioner 2000
- i. Spicer Accounting, Inc. v. United States 1990
- j. Joseph Radtke, S.C. v. United States,1989
- k. etc.....



## 3. IRS guidelines for determining Reasonable Compensation for S Corps

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1. IRS Definition of Reasonable Compensation: “Reasonable compensation is the value that would ordinarily be paid for like services by like enterprises under like circumstances” ~ IRS Code: Section 162-7(b)(3)
2. Compensation must be reasonable and (2) payments must be in fact for services rendered. ~IRS Code 162(a)(1)
3. Notice of Acceptance as an S Corporation
4. W-2 Or 1099
  - a. Revenue Ruling 74-44; IRC §states:
    - i. An officer of a corporation is considered an employee
    - b. [Employee](#) or Independent Contractor
      - i. Under common-law rules, anyone who performs services for you is your employee ***if you can control what will be done and how it will be done.***
5. [IRS Reasonable Compensation Guidelines](#)
  - a. “The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation. As such, we need to look to the source of the S corporation's gross receipts.”
  - b. The three major sources of gross revenue are:
    - i. Services of non-shareholder employees, or
    - ii. Capital and equipment
    - iii. Services of shareholder
6. [Fact Sheet 2008-25](#)

7. Factors in determining reasonable compensation:
  - a. Training and experience
  - b. Duties and responsibilities
  - c. Time and effort devoted to the business
  - d. What comparable businesses pay for similar services
  - e. The use of a formula to determine compensation
  - f. Payments to non-shareholder employees
  - g. Compensation agreements
  - h. Timing and manner of paying bonuses to key people
  - i. Dividend history

## 4. Profitability V. Distribution and Reasonable Compensation

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1. IRS guidelines: “The amount of reasonable compensation will never exceed the amount received by the shareholder either directly or indirectly”

~ FS-2008-25

2. Example 1:

- a. Scott Stone 100% of Stone Concrete (S Corp)
- b. Scott’s RC figure = \$68,788
- c. Stone Concrete Net Profit = \$210,000
- d. Scott takes \$200,000 out of Stone Concrete
- e. Scott receives wages (RC) of \$68,788
- f. Scott receives a distribution of \$131,212

3. Example 2:

- a. Scott Stone 100% of Stone Concrete (S Corp)
- b. Scott’s RC figure = \$68,788
- c. Stone Concrete Net Profit = \$23,000
- d. Scott takes \$30,000 out of Stone Concrete
- e. Scott receives wages (RC) of \$30,000
- f. Scott receives a distribution of \$0

4. Example 3:

- a. Scott Stone 100% of Stone Concrete (S Corp)
- b. Scott’s RC figure = \$68,788
- c. Stone Concrete Net Profit = \$150,000
- d. Scott takes \$0 out of Stone Concrete
- e. Scott receives wages (RC) of \$ 0.00
- f. Scott receives a distribution of \$ 0.00

## 5. Example 4:

	Year 1	Year 2	Year 3	Total
Scott RC	\$70k	\$70k	\$70k	\$210k
Net Profit	\$150k	\$175K	\$200K	\$525K
Scott Takes	\$0	\$0	\$500k	
Wages	\$0	\$0	\$210	
Distribution	\$0	\$0	\$290k	

	Year 1	Year 2	Year 3		Years 1-3
Reasonable Compensation	\$70,000	\$70,000	\$70,000		\$210,000
FICA 12.4% (2024 limit 168,600)	\$8,680	\$8,680	\$8,680		\$20,906
Medicare 2.9% (all)	\$2,030	\$2,030	\$2,030		\$6,090
Medicare Surtax 0.9% (over \$200K)	\$0	\$0	\$0		\$90
	\$10,710	\$10,710	\$10,710		\$27,086
			Total	\$32,130	
				-\$27,086	
			Tax Savings	\$5,044	

6. IRS cannot create compensation. IRS can only re-characterize what was actually paid; it cannot force a shareholder to take money out of the corporation.

7. Glass Blocks Unlimited – Fredrick Blodgett
  - a. This scenario is possible because Reasonable Compensation is not tied to Profit or Loss but to Distributions
  - b. Background on this case: Glass Blocks Unlimited – Fredrick Blodgett
    - i. 2007 Net Income = \$877
    - ii. 2007 Transferred in = \$45,000
    - iii. 2007 Transferred out = \$30,844
    - iv. 2007 Salary = Zero
  - c. IRS Position
    - i. Transfer in was a contribution to capital (basis)
    - ii. Transfer out was a distribution (Return of basis)
    - iii. Reasonable Compensation must be paid before a distribution can be made
  - d. Glass Blocks Position
    - i. Transfer in was a shareholder loan to GBU
    - ii. Transfer out was a repayment of the shareholder loan
    - iii. Reasonable Compensation does not apply
  - e. Courts have established a nonexclusive list of 13 factors they consider when evaluating whether the funds transferred into the S Corp were a loan or actually a capital contribution. Such factors include:
    1. the names given to the documents that would be evidence of the purported loans
    2. the presence or absence of a fixed maturity date
    3. the likely source of repayment
    4. the right to enforce payments
    5. participation in management as a result of the advances
    6. subordination of the purported loans to the loans of the corporation's creditors
    7. the intent of the parties
    8. the capitalization of the corporation
    9. the ability of the corporation to obtain financing from outside sources

10. thinness of capital structure in relation to debt
  11. use to which the funds were put
  12. the failure of the corporation to repay
  13. the risk involved in making the transfers
- f. Where the expectation of repayment depends solely on the success of the borrower's business, rather than on an unconditional obligation to repay, the transaction has the appearance of a capital contribution.

## 8. The Davis Case 1994 – Did the IRS really lose?

- a. Mile High Calcium Owned by:
  - i. Carol L. Davis
  - ii. Henry Adams (husband)
  - iii. Transfers In and Out
  - iv. Assessment \$39,220
- b. Henry Adams – President (Officer)
  - i. No Active Participation
  - ii. Worked for outside employers
  - iii. There is an exception for officers who perform only minor services... (Treas. Reg. § 31.3121(d)-(1)(b))
- c. Carol L. Davis
  - i. 12 hours per week
  - ii. Services worth \$8.00 hour
  - iii. FICA & FUTA \$647.32

## 5. Reasonable Compensation & the IRS

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1. 1990 – 2020:
  - a. 1990's: A Myth is Born ~ All or Nothing
  - b. 2000's: Say Goodbye to the Myths ~ Hello to Guidance
  - c. 2010's: Facts NOT Myth ~ Enforcement
  - d. 2021+: Enforcement?
2. Circa 1990's: A Rule of Thumb is Born AKA the RC Myth
  - a. Determine RC as a percentage of distributions, profit, sales etc...  
**"The 50/50 Rule"**
  - b. Pay the SS Maximum **"The Safe Harbor Rule"**
  - c. The IRS doesn't care unless you get greedy **"Pig's Get Fat – Hogs Get Slaughtered Rule"**
  - d. *"Rules of thumb were likely strategies to keep off the IRS's radar and nothing more"*
3. Circa early 2000's: All or Nothing (aka Pigs get fat and hogs get slaughtered)
  - a. [Joly v. Commissioner 2000](#)
    - i. IRS established its authority to reclassify distributions as wages if paid in lieu of reasonable compensation.
  - b. [Veterinary Surgical Consultants, P.C. vs. Commissioner 2001](#)
  - c. [Joseph M. Grey Public Accountant, P.C. 2002](#)
    - i. Reinforced the employment status of shareholders as employees
  - d. **2002 TIGTA Report**
    - i. TIGTA 07-2002 The IRS does not always address S Corp officer compensation during examination
4. Circa 2005
  - a. [2005 Compliance Study](#)
  - b. [2008 Fact Sheet](#) ✓
  - c. [2009 GAO Report](#)

## 5. 2010's

- a. [2010 Watson 1](#) ✓
- b. 2011 Form 1125-E
  - i. 2011 Required for Gross Revenue 500k+
  - ii. Disclosure Standards
    - 1. Dollar Amounts must be verifiable
    - 2. Taxpayer must be able to demonstrate the origin of the amount claimed
    - 3. Taxpayer must be able to show he entered the amount in good faith
- c. [2012 Watson 2](#) ✓
- d. 2012 TIGTA Report
  - i. TIGTA June 2012: The Recommended Adjustments From S Corporation Audits Are Substantial, but the Number of No-Change Audits Is a Concern
- e. [2013 McAlary](#) ✓
- f. [2013 Glass Blocks](#) ✓
- g. [2014 Job Aid](#)
  - i. Companies have the burden of showing that compensation is reasonable
  - ii. Three Approaches
- h. [2017 Memo](#)
  - i. No Tax Court for Reasonable Compensation
  - ii. Notice of Employment Tax Determination under IRC §7436 - Additional Compensation to Officer Employees
- i. 2018 Reasonable Compensation added to Audit Checklist
- j. 2021 [TIGTA](#) Report
  - i. >1% of S Corps Selected for Traditional Examination
  - ii. August 2020 Established a National Compliance Initiative Project to focus additional resources on the issue of Officer Compensation



6. 2020s **Enforcement** & the Reasonable Compensation **Myth**
  - a. 2015 \$5,000 Preparer Penalties
    - i. IRS Preparer Penalties \$5,000 [IRC sec. 6694](#) & [Circular 230](#)
      1. Larry Jacobson, CPA/JD- AICPA [Tax Preparers Beware](#)
      2. ...the IRS does expect preparers to have appropriate checklists for different types of clients. The IRS appropriately expects preparers to elicit information from taxpayers that would be reasonably necessary to prepare a tax return.
      3. ...the IRS does not expect the preparer to merely accept the information given to her by the client. Rather, the IRS anticipates the preparer will review the information given by the client, compare that information to a checklist or some other written procedure and ask the client for additional information if necessary for the preparer to complete a professional tax return.
      4. ...the IRS does require the preparer to be proactive in terms of asking for the right information necessary to prepare tax returns, even if it means the preparer will need to spend more time with the client during the preparation process.
      5. ...penalties can and will be imposed on preparers who fail to make reasonable inquiries of their clients during the preparation process.
    - b. 2016-ish Enterprise-Wide Employment Tax Program
    - c. 2018 2,500 Agents Trained
    - d. 2018-ish RC added to examiners checklist
    - e. [2019 Forbes S Corp Audits to Rise](#)

7. 2024+: What's at Stake – S Corp Owner:
  - a. Tax & Interest
  - b. Penalties
    - i. Late
    - ii. Accuracy
    - iii. Underpayment
  - c. Multiple Years
  - d. Retirement Plans
  - e. S Corp Status Revoked
8. 2024+: What's at Stake – CPA/EA/Tax Preparer:
  - a. Preparer Penalties
  - b. Malpractice Claim
  - c. Multiple Clients

## 6. Determining Reasonable Compensation

### IRS Job Aid

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1. IRS [Job Aid \(Appendix\)](#)
  - a. This Job Aid is not an official pronouncement of law, and cannot be used, cited, or relied upon as such
  - b. Companies have the burden of showing that compensation is reasonable
  - c. Discusses Three Approaches
  - d. Good Resource for Audit
  - e. [Companion book by Michael A. Gregory – Amazon](#)
  - f. [Abbreviated Version Free at MikeGreg.com](#)
  
2. [Step by Step Guide: How to Calculate Reasonable Compensation](#)

## Cost Approach

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1. AKA: **Many Hats Approach** – similar to pricing out the cost of a new home. Start with a set of plans, do a take-off of what's needed. Multiply everything out and add it together = cost to build the house.
  - a. Takes into account all tasks performed
  - b. Apportion Time
  - c. Skill/Proficiency – similar to grade of finishes in a home
  - d. Comparability data – what things cost
2. Comparability Data
  - a. Cross Industry comparable wage data
  - b. Local Level
  - c. Hourly
3. Small Business Owners who wear multiple hats

## Market Approach

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1. AKA **Industry Comparison Approach** – Similar to valuing a house in a tract neighborhood. Neighborhoods are different but the homes in them are similar. Find other homes that have sold in the same neighbor with roughly the same size and finishes to come up with a value for your home.
  - a. Industry & Size comparable wage data
  - b. Usually Management or Executive level i.e. GM or CEO
  - c. Annual
2. Medium Businesses

## Income Approach

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1. AKA Independent Investors Test – similar to valuing commercial real estate. The investor may be curious what the market and/or cost approach is, but what their really interest in is the return on their investment.
  - a. No Comparable Wage Data
  - b. ROI v. Reasonable Compensation
  - c. Outliers
    - i. Unique Occupation, Skill or Duties
    - ii. Superior Employee/Key Employee (Phenomenal Results)
  - d. 2nd Opinion/Test

## Outliers

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**Outliers:** If an individual is truly unique because of special skills, duties or spectacular results, whose achievements are so great that they deserve compensation above that of their peers, then his or her replacement compensation may need to be determined by means other than comparability data. Some people are simply off-the-chart.

- Unique Occupation Skill or Duties
- Spectacular Results
- Superior/Key Employee

## 7. Tips & Advice

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1. Educate: Send Issue Letter(s) See Appendix A
2. Include in Engagement Letter and 1120-S preparation fee
3. Stress Test – See Appendix B
4. *“The first with a fact-based figure wins”* Burden of Proof IRS Sec. 7491
5. How your peers do it: [Three Steps to Reasonable Compensation Compliance For All Of Your S Corps](#)
6. Reasonable Compensation - Sensitive Issue
  - a. Reasonable Compensation is defined by valuation professionals as the hypothetical replacement cost of an owner or key manager of a business.
7. Tips from the Experts
  - a. Overlooked on Tax Returns: Stephen D. Kirkland
    - i. Occupation next to signature – Form 1040
    - ii. Percent of time devoted to business – Form 1125-E
    - iii. Business activity code – NAICS/SIC
    - iv. *An opinion has value if it is supported and can be defended.”*
  - b. Corporate Minutes: Dennis Tafelski - Internal Revenue Agent - Retired
    - i. One of the first things an examiner does during an audit is ask to see the corporate minute book.
    - ii. If the examiner sees that the taxpayer took the time to best determine what shareholders should be paid.
    - iii. Indicate this in their lead sheet of audit issues and not continue to pursue this issue.
  - c. Reasonable Compensation: Application and Analysis for Appraisal, Tax and Management Purposes: Ron Seigneur & Kevin Yeanoplos

## Conclusion

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1. Number one problematic area per GAO & TIGTA:
  - a. Compensation Paid to Shareholders Who Perform Services
  - b. Underpayment of salaries results in the large underpayment of FICA taxes
2. The IRS & courts have made it clear that distributions to a shareholder who performs services to their S Corp will be re-characterized as wages if the distributions are actually disguised compensation.
3. Who should research and document their Reasonable Compensation figure
  - a. Any Shareholder-Employee of an S Corp who performs services for their company.
4. No Safe Harbor
  - a. An accounting method that avoids legal or tax regulations and allows for a simpler method (usually) of determining a tax consequence than those methods described by the precise language of the tax code.
5. Reasonable Compensation is Subjective
  - a. "Determining an employee's reasonable compensation is dependent upon a number of factors and is far from an exact science."

6. How to support your Reasonable Compensation Figure:
  - a. Develop a consistent year to year Reasonable Compensation policy
  - b. Determine your Reasonable Compensation figure using the IRS guidelines, Job Aid and the 9 factors handed down by the courts
  - c. Add your Reasonable Compensation documentation, reasoning, and notes to your corporate minutes
  
7. Best Practice: Compensation must be both Reasonable & Supportable with a clear documentation outlining how the compensation figure was reached
  
8. Steps to reach a replacement cost or FMV figure
  - a. Make a complete list of all the services you provide to your S Corp
  - b. Apportion your time among all the services listed
  - c. Rate your level of expertise and experience for each service performed
  - d. Gather wage data on all the services listed and at the appropriate level of expertise
  - e. Assemble all your research and data and calculate your Reasonable Compensation figure





Reasonable Compensation Simplified™

# Notes

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# Appendix A ~ Issue Letter

## Reasonable Compensation Issue Letter (PAPER DELIVERY)

**NOTE TO PRACTITIONER: Include a printed copy of the brochure titled [What is Reasonable Compensation? A primer for S Corps](#) with the Issue Letter**

Mr. Tom Jones  
111 First Street  
Anytown, CO 88888

Dear Tom,

As your tax advisor, I need to alert you to new risks related to the accuracy of your Reasonable Compensation figure. (*Reasonable Compensation is the salary or wage that you, a shareholder-employee of an S Corp, must pay yourself for the work you perform for your company.*)

There has been a lot of information in the news regarding the IRS funding outlined in the recent IRA22 legislation. One of the key takeaways is clear - **the IRS intends to audit S-corporations at a much higher rate in the near future, specifically focusing on reasonable compensation.**

Below is some more info on what we're seeing regarding the IRS funding.

In a Forbes article, dated January 10, 2023, it reads:

“Hiring more [IRS Revenue Agents] may allow the IRS to increase audits (which are at an all-time low) but those audits would likely be focused on higher-income pass-through entities (or PTEs). **Many PTEs have been skirting tax regulations concerning** deductibility of losses (partnerships and S-corporations) and **reasonable compensation for officers** (S-corporations) for years and many in the tax industry think that additional scrutiny is long overdue.”

This echoes the letter from U.S. Secretary of the Treasury Janet L. Yellen sent to the Commissioner of the IRS in August 2022:

“Enforcement resources will focus on high-end noncompliance. There, sustained, multi-year funding is so critical to the agency’s ability to make the investments needed to pursue a robust attack on the tax gap by **targeting crucial challenges**, like large corporations, **high-net-worth individuals and complex pass-throughs**, where today the IRS has resources to initiate just 7,500 audits annually out of more than 4 million returns received.”

To protect you, we must take the following actions when determining your reasonable compensation:

- Use an IRS approved method
- Use an unbiased source of data
- Keep detailed records of how we arrived at your figure & what data sources were used
- Stress test your figure

The penalties for taking low, or no, reasonable compensation are steep for both you as the S-Corp owner and for me as your practitioner. The good news is that we have tools available that meet the above requirements and mitigate the risks associated with an IRS Reasonable Compensation challenge. Please contact me if you would like to discuss this issue further and/or to have (firm name) complete a Reasonable Compensation analysis with your input. We typically charge \$800 to complete an analysis, however if you have us complete a report before the end of this year, we will decrease our fee to \$500.

A Reasonable Compensation analysis is an independent, unbiased report that establishes your Reasonable Compensation, using criteria outlined by the IRS and Courts, and provides a defensible position to an IRS challenge.

A Reasonable Compensation challenge can be costly. Typically, taxes, penalty, and interest are more than double the original tax that would have been owed – plus costs for amending returns (*all totaled, usually in the tens of thousands of dollars*). In addition, the IRS is holding Tax Preparers responsible for unreasonable compensation, assessing *preparer penalties* of up to \$5,000 for signing off on an unreasonably high/low compensation figure.

Read the attached brochure to learn more about Reasonable Compensation.

I appreciate your business and I will work hard to keep you from paying even one penny more than is required, however, if we don't have a sound basis for your Reasonable Compensation going forward, I won't be able to represent you in the future.

Please call me at your earliest convenience to take the necessary steps to protect yourself and your company.

Sincerely,

(CPA name)  
(CPA Firm)

### Sources

**Forbes Article:** <https://go.rcreports.com/forbes-jan-10-2023>

**Letter from U.S. Secretary of the Treasury Janet L. Yellen:** <https://home.treasury.gov/news/press-releases/jy0918>

# What is Reasonable Compensation?

## A Primer for S-Corp Owners



### Reasonable Compensation in a Nutshell

1. All S-Corp shareholder-employees **must** pay themselves a reasonable salary (i.e. Reasonable Compensation) via W-2 **BEFORE** any distributions are taken. It's the law.
2. You should complete a Reasonable Compensation analysis each year using one of the three IRS-approved approaches.
3. Keep a record of all supporting documentation for your figure each year.

There are many tax benefits to filing as an S-Corp, but you should be aware of the additional responsibilities you have including:

- S-Corp shareholder-employees must pay themselves reasonable wages (i.e. Reasonable Compensation) via W-2 before taking any distributions from the business
- You will need to file an additional tax return for the business as an S-Corp
- Some states impose additional fees to S-Corps
- There may be filing fees associated with becoming an S-Corp

If you aren't sure if an S-Corp is right for you, ask your accounting professional to run an Entity Planning Analysis to see what makes the most sense for your business.

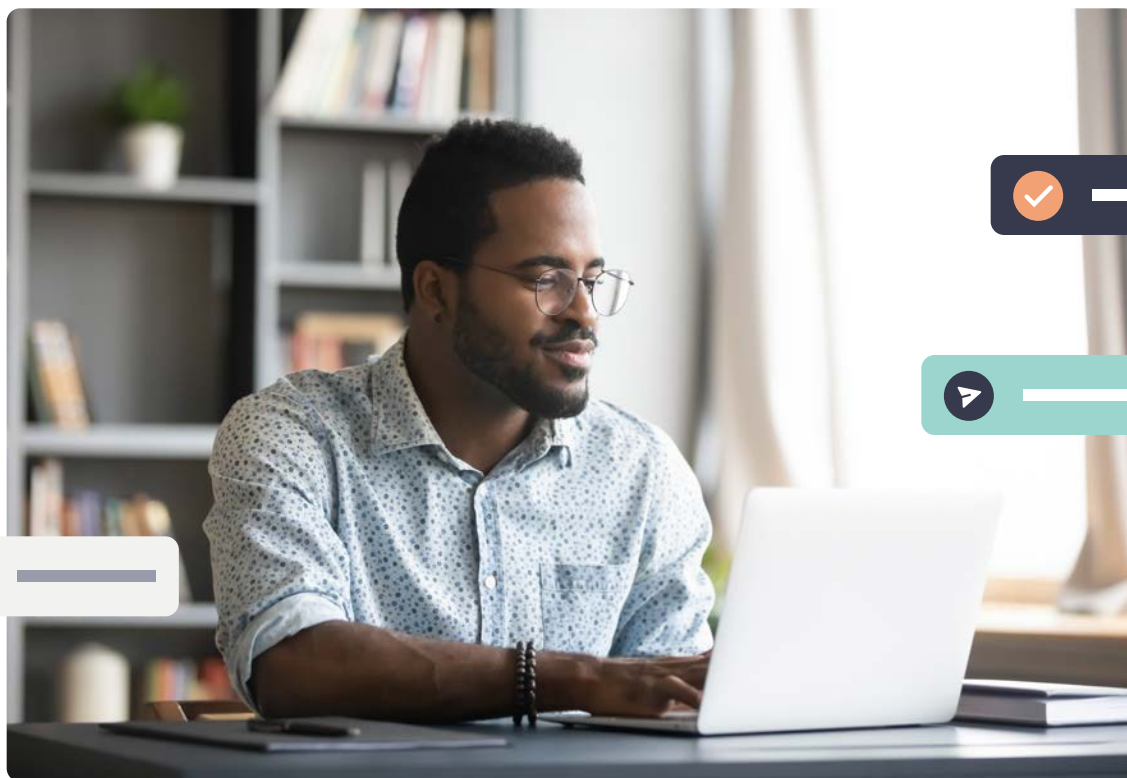
## What is Reasonable Compensation?

The biggest struggle for most S-Corp owners is defining Reasonable Compensation. The IRS defines Reasonable Compensation as: the value that would ordinarily be paid for like services by like enterprises under like circumstances. ~ IRS Code: Section 162-7(b)(3)

To put it in simpler terms, you can ask yourself, "How much compensation would be paid for this same position, held by a non-owner in an arms-length employment relationship, at a similar company?"

A few key things to keep in mind:

- Reasonable Compensation is based on the value of the service provided, not profits or distributions.
- Wages (i.e. Reasonable Compensation) should be paid before distributions and must be paid via W-2.
- A shareholder-employee can take wages without taking a distribution, but not vice versa.
- A shareholder-employee who does not want to take Reasonable Compensation can refuse all compensation and play "catch-up" in a later year.



## How Do You Calculate Reasonable Compensation?

The IRS defines three approved approaches to calculate Reasonable Compensation: the Cost Approach, Market Approach, and Income Approach. Each approach is useful in different situations and your accounting professional can help determine the appropriate approach to use based on your business.

Here are some helpful tips when it comes to Reasonable Compensation:

- 1. Run a Reasonable Compensation analysis every year.** Just like wages can change over time, so can Reasonable Compensation. What was considered reasonable 5 years ago is most likely no longer accurate.
- 2. Document your Reasonable Compensation figure.** Keep a record of all data used and all calculations completed to arrive at your Reasonable Compensation figure each year. This will come in handy should you ever be audited.
- 3. Use unbiased data.** If you are ever audited, the IRS will be looking to see that you used unbiased data for your calculations – that is, data that is not influenced by an interested party and meets criteria to be determined accurate. Often sites like Glassdoor and Payscale are considered biased because the sample sizes and reporting methods can result in inaccurate data. Look for sites using sources such as the Bureau of Labor Statistics and the U.S. Census Bureau.

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## What Happens if I Don't Take Reasonable Compensation?

If you don't take Reasonable Compensation but you do take distributions from the business, you are opening yourself up to potentially large financial consequences including back taxes, penalties, and interest levied by the IRS. The IRS can also revoke your S-Corp status and they have been known to levy preparer penalties on tax preparers (i.e. your tax accountant).

**The bottom line:** If you file as an S-Corp, all shareholder-employees must take a reasonable salary via W-2 before taking any distributions.

# Appendix B

## Preparer Penalty Check List and Stress Test

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The best way to prevent preparer penalties and protect your client from a Reasonable Compensation challenge is to use a check list to make sure you have adequately covered Reasonable Compensation with your S Corp clients and stress tested their Reasonable Compensation figure against some of the factors the courts use.

CLIENT	NAME:	Yes	No
1	Send Issue Letter to client (Educate your client)		
2	Did you run a Reasonable Compensation Report on the client?		
	<b>OR</b>		
	Did the client provide Independent Research and Documentation to support their Reasonable Compensation Figure?		
3	Does the client's Reasonable Compensation figure, on its face, appear to be reasonable based on the client's:		
3a	Training and Experience		
3b	Duties and Responsibilities		
3c	Time and Effort devoted to the business		
3d	Location of the business		
4	Did the client make as much or more than any non-shareholder-employees of the business, for performing essentially the same services? (Internal Consistency)		
5	Did the client pay themselves via W-2 (It's the Law)		

If you answered YES to all questions above you are in good shape. You have made a reasonable attempt to comply with IRS guidelines and court rulings and this check list creates a defensible position for you and your client should the IRS raise the issue.

Save a copy of this check list in your client's file.

## Appendix C

# Reasonable Compensation Case Study Scott Stone ~ Stone Concrete

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Following is a Reasonable Compensation case study for Scott Stone. This case study follows Scott through his career and determines Reasonable Compensation for Scott at three different points in his career using the three different approaches recognized by the IRS.

Scott is the owner of Stone Concrete. His business specializes in concrete patios, sidewalks, driveways etc...





## Scenario One:

Meet Scott Stone at age 30. Scott owns Stone Concrete, an S Corp with seven full-time employees including Scott and annual gross income of \$250,000.

Because Scott’s business would be considered a small business, we will be determining Scott’s Reasonable Compensation using the **Cost Approach** (AKA the multiple hats approach). This approach tends to work best with small businesses where the owner performs multiple duties (wears multiple hats).

We have gathered the following information on Scott and his business:

How many hours do you work per week on average? <b>40+</b>				
State your business is located <b>Illinois</b>				
County or township your business is located <b>Cook</b>				
Yes/No	Title	Definition	Time %	Proficiency
X	Sales Representatives	Sell goods or services for wholesalers or manufacturers to businesses or groups of individuals. Work requires substantial knowledge of items sold.	10%	Below Average
X	Bookkeeper	Compute, classify, and record numerical data to keep financial records complete. Perform any combination of routine calculating, posting, and verifying duties to obtain primary financial data for use in maintaining accounting records. May also check the accuracy of figures, calculations, and postings pertaining to business transactions recorded by other workers.	10%	Below Average
X	Purchasing Clerk	Compile information and records to draw up purchase orders for procurement of materials and services.	5%	Average
X	Business Office Manager	Plan, direct, or coordinate one or more administrative services of an organization, such as records and information management, mail distribution, facilities planning and maintenance, custodial operations, and other office support services.	15%	Average
Please list any specialized tasks which fall outside the common tasks that you've already selected from. You may add as many specialized tasks as you need to adequately account for all the other tasks you perform for your business regularly throughout the year and then rate your skill level for each task added. (Example: Veterinarian; Hair Stylist; Pastry Chef; Etc...)				
Title	Description	Time %	Proficiency	
Concrete Finisher	Smooth and finish surfaces of poured concrete, such as floors, walks, sidewalks, roads, or curbs using a variety of hand and power tools. Align forms for sidewalks, curbs, or gutters; patch voids; and use saws to cut expansion joints.	30%	Above Average	
Maintenance Mechanic	Perform work involving the skills of two or more maintenance or craft occupations to keep machines, mechanical equipment, or the structure of an establishment in repair. Duties may involve pipe fitting; boiler making; insulating; welding; machining; carpentry; repairing electrical or mechanical equipment; installing, aligning, and balancing new equipment; and repairing buildings, floors, or stairs.	30%	Above Average	
		100%	TOTAL	

After inputting the above data into RCReports the following report is produced:

(Following are pages 1-2 of what is typically a 5-7 page report that would include additional information on methodology, court cases, IRS info and sample corporate minutes. View the entire report [HERE](#))



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## Tax & Valuation

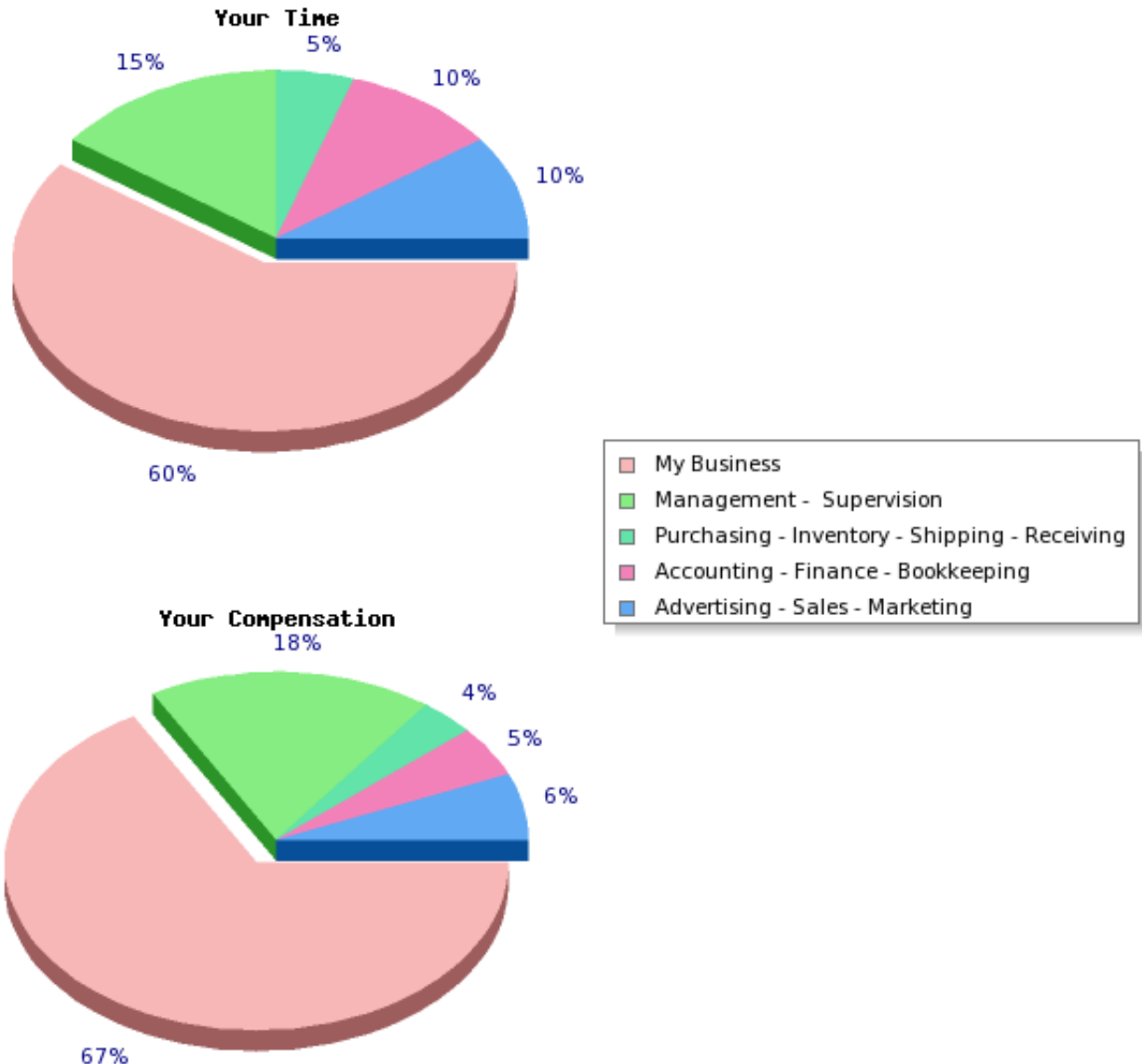
### Report for Scott Stone of Stone Concrete, Inc.

#### Your estimated annual Reasonable Compensation: \$68,788

Thank you for entrusting Paul Hamann of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your S Corporation based on your responsibilities and the duties that you perform annually. Reasonable Compensation is defined by the IRS as "The value that would ordinarily be paid for like services by like enterprises under like circumstances".

The calculated salary of **\$68,788** was determined to be reasonable compensation based on the type of work performed, the skill level of the work performed and the number of hours the work is performed annually. You told us that you work **2080** hours per year in **Cook County, IL**. Our analysis indicates the annual salary of \$68,788 would be a reasonable cost to hire employee(s) to perform the duties and responsibilities that you currently perform.

Potomac Tax and Valuation, PC recommends completing a reasonable compensation report annually.



*Annual Salary and Reasonable Compensation are used interchangeably in this report. All salary and reasonable compensation figures are expressed annually and in U.S. dollars.*



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## Tax & Valuation

### Report for Scott Stone of Stone Concrete, Inc.

#### Advertising - Sales - Marketing

10% of  
your time

208 hours  
per year

6.4% of  
your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Sales Representatives	Below Avg.	100%	10%	208.0	\$ 21.18	\$ 4,405

#### Accounting - Finance - Bookkeeping

10% of  
your time

208 hours  
per year

4.89% of  
your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Bookkeeper	Below Avg.	100%	10%	208.0	\$ 16.16	\$ 3,361

#### Purchasing - Inventory - Shipping - Receiving

5% of  
your time

104 hours  
per year

3.57% of  
your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Purchasing Clerk	Average	100%	5%	104.0	\$ 23.61	\$ 2,455

#### Management - Supervision

15% of  
your time

312 hours  
per year

18.29% of  
your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Business Office Manager	Average	100%	15%	312.0	\$ 40.33	\$ 12,583

#### My Business

60% of  
your time

1,248 hours  
per year

66.85% of  
your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Concrete Finisher	Above Avg.	50%	30%	624.0	\$ 45.21	\$ 28,211
Maintenance Mechanic	Above Avg.	50%	30%	624.0	\$ 28.48	\$ 17,772

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## Scenario Two:

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Meet Scott Stone at age 45. Stone Concrete has grown significantly, is still an S Corp and has grown to 35 employees and 7 million in annual gross revenue. Scott's primary job function for Stone Concrete is now CEO.

Because Scott's business would be considered a medium business, we will be to determining Scott's Reasonable Compensation using the **Market Approach** (AKA the industry comparison approach). This approach tends to work best when the company is larger, more mature and the business owner is acting in a management capacity.

We have gathered the following information on Scott and his business:

In order to help us build your Reasonable Compensation profile, tell us a little more about yourself and your business:	
Industry	Specialty trade contractors
Occupation	CEO
State	Illinois
Metro area	Chicago
Number of employees	35
Adjusted Gross Profit	3.5 million
Business performance versus peers	Above average
Owner experience versus peers	High
Hours worked per week on average	55

After inputting the above data into RCReports the following report is produced:

(Following is the first page of what is typically a five page report that would include additional information on methodology, court cases, IRS info and sample corporate minutes View the entire report [HERE](#))



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## Tax & Valuation

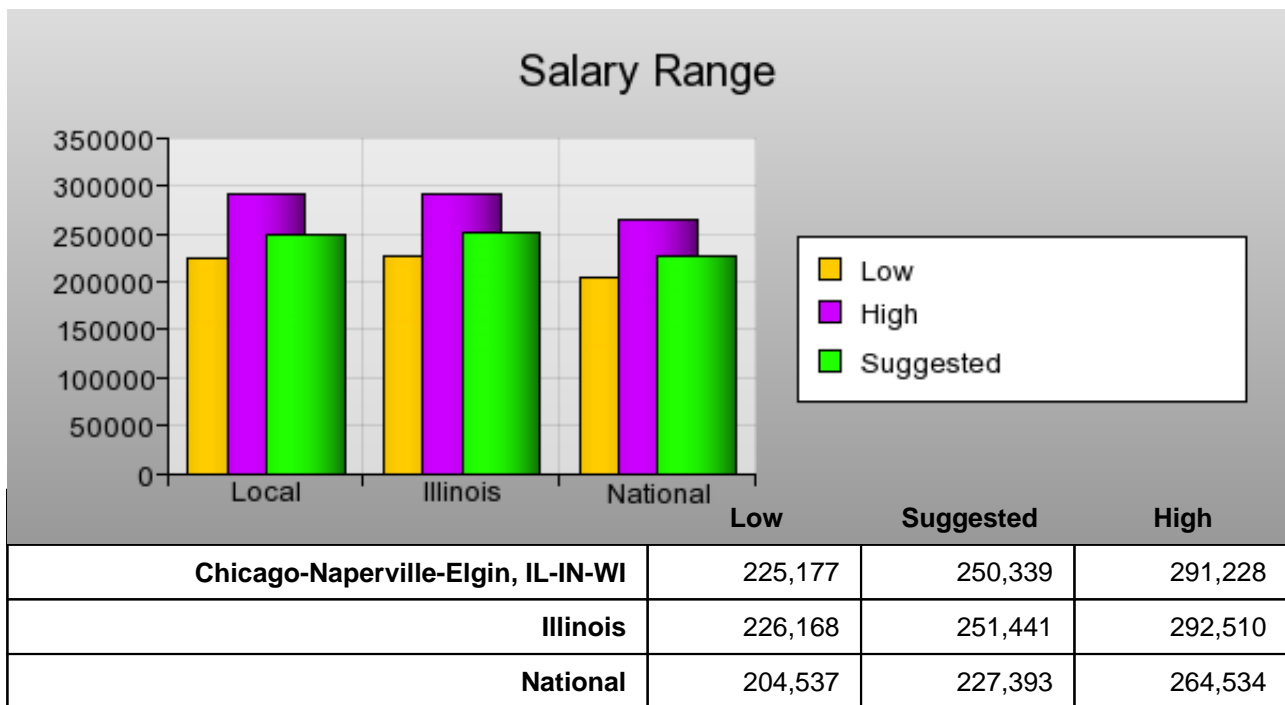
Report for Scott Stone of Stone Concrete, Inc.

### Your estimated annual Reasonable Compensation: \$250,339

Thank you for entrusting Paul Hamann of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your S Corporation based on your responsibilities and the duties that you perform annually. Reasonable Compensation is defined by the IRS as "The value that would ordinarily be paid for like services by like enterprises under like circumstances".

Your suggested salary range: \$204,537 to \$292,510 with a suggested salary of \$250,339 was determined to be Reasonable Compensation based on your role in the company, industry, size of the business, time devoted to the business, your experience and location. Any wage selected within the suggested range or expanded geographical area(s) is acceptable and within a 90% confidence interval.

Potomac Tax and Valuation, PC recommends completing a Reasonable Compensation report annually.



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All salary and reasonable compensation figures are expressed annually and in U.S. dollars.*

## Scenario Three:

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Meet Scott at age 55. Ten years earlier Scott started a new company called Stone Technologies, a C Corp. Scott has developed multiple new technologies for the concrete industry and has patented them.

Scott is the only employee of Stone Technologies, and Scott would best be classified as an inventor. His business revenue is growing at an exponential rate, and we are having a very difficult time finding comparable wage data for Scott. Because of this we are going to be determining Scott's Reasonable Compensation using the **Income Approach** (AKA the independent investors test).

This approach does not rely on comparable wage data, but instead relies on a simple algorithm used by the IRS. This approach tends to work best for what we term outliers, these are business owners who have a unique occupation or who are achieving results significantly better than their peers. Therefore comparability data is not available or appropriate to use.

We have gathered the following information on Scott's business:

In order to help us build your Reasonable Compensation profile, tell us a little more about yourself and your business:	
Estimated FMV beginning of the year	6,000,000
Estimated increase in FMV by year end	1,750,000.00
Target return (independent investor rate)	20%

After inputting the above data into RCReports the following report is produced (included 1 of 5 pages):

(Following is the first page of what is typically a five page report that would include additional information on methodology, court cases, IRS info and sample corporate minutes. View the entire report [HERE](#))



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## Tax & Valuation

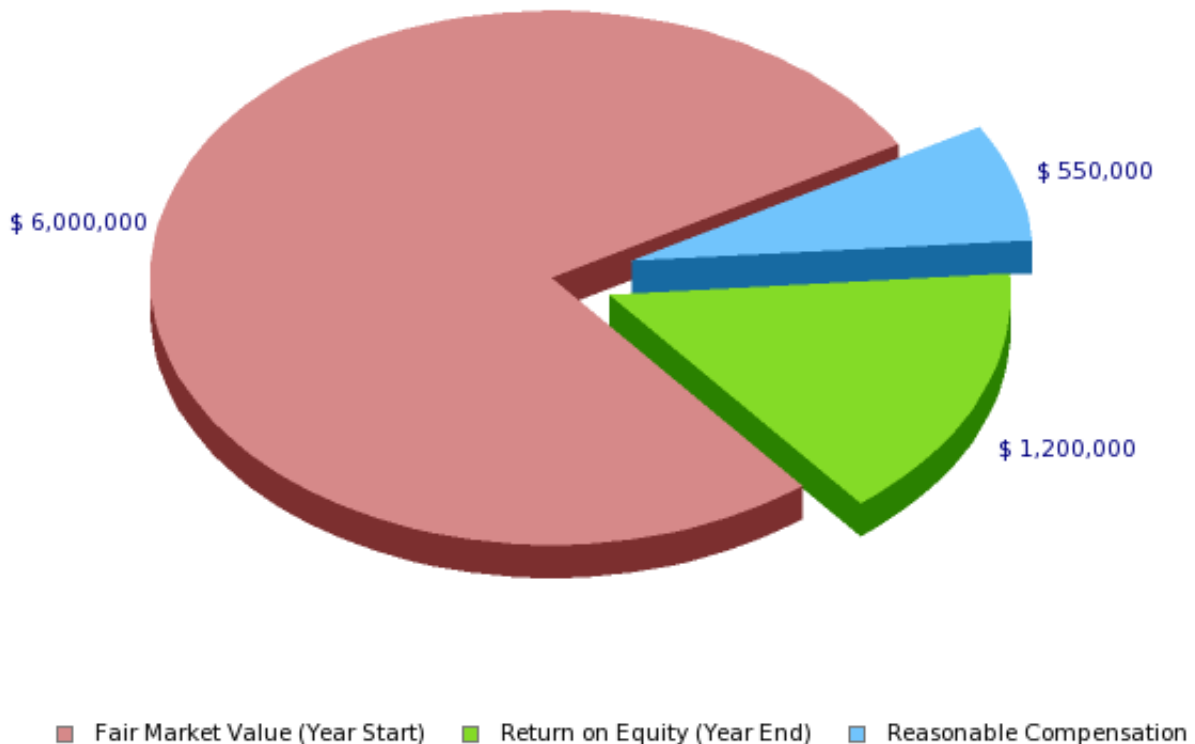
### Report for Scott Stone of Stone Technologies, Inc.

#### Your estimated annual Reasonable Compensation: \$550,000

Thank you for entrusting Paul Hamann of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your C Corporation based on your responsibilities and the duties that you perform annually. Reasonable Compensation is defined by the IRS as "The value that would ordinarily be paid for like services by like enterprises under like circumstances."

The calculated salary of \$550,000 was determined to be Reasonable Compensation based on the increase in the Fair Market Value of your company over a one year time frame and a Return on Investment of 20.00% in conjunction with your efforts.

Potomac Tax and Valuation, PC recommends completing a Reasonable Compensation report annually.



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All salary and reasonable compensation figures are expressed annually and in U.S. dollars.*