

Reasonable Compensation for S Corporation Owners

SELF-EMPLOYED OR EMPLOYEE

All self-employed people are business owners. But not all business owners are self-employed. The owner of an S Corp isn't considered self-employed in the eyes of the IRS, unlike sole proprietors or partners in a partnership. Instead, they're considered both an employee (if they work in the business) and a company shareholder. This distinction is critical because owners of S Corps don't pay self-employment tax on their share of the company's profits.

GET TO WORK

To prevent owners from taking all business income as a distribution of profit and avoid paying any self-employment tax, the IRS requires that owners who provide services to the S Corp collect a reasonable salary.

SALARY OR PROFITS

Determining whether a shareholder payment is a paycheck or profit distribution, first look at how much of the company's sales revenue was generated by the shareholder's personal services. If the company has no other employees or subcontractors, then a reasonable amount of payments should be classified as wages since the shareholder did the work.

WHAT'S REASONABLE?

Although there's no clear definition of what's reasonable compensation, there are a few factors to consider, such as:

- Training and experience

- Duties and responsibilities
- Time and effort devoted to the business
- Competitive costs for similar services
- Payments to non-shareholder employees

IT'S TAXING

Payments to S Corp owners for services rendered are treated no differently than the salary you would pay an employee. Payroll taxes including FICA and federal and state income tax must be withheld from the paycheck, and the company must pay FUTA and state unemployment taxes. Form W-2 will be provided to the owner in January, as with all employees.

S Corporations are complex compared with other business structures, so if you're considering S Corp tax status for your business, consult with your tax professional.



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