# Is Your S-Corporation Compensation Reasonable? Here's How to Avoid an IRS Audit

A great tax-saving feature of S-corporations is that the net earnings are exempt from self-employment tax. But the trade-off is that S-corp shareholders are expected to take a salary that qualifies as "reasonable compensation." Since wages are subject to payroll taxes, this is an incentive to keep salaries low and save on payroll taxes, and to boost the tax-free cash distributions. The IRS is hunting for easy sources of additional tax and S-corp officer wages are a favorite target these days. IRS agents are especially eager if officer salaries are low in comparison to distributions. If the IRS reclassifies your distributions as wages, you'll owe payroll taxes for those wages. And there may be penalties and interest thrown in for good measure.

How do you know if your compensation is reasonable? Of course, the IRS doesn't define "reasonable compensation." Instead they look at the following factors:

- 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

Another approach is to look at comparable salaries for your industry and region. Websites like Salary.com and Indeed.com are loaded with data that give you a good range. Now is the time to look ahead to 2016 and set your wage base for the year. While it's possible to wait until year-end to recharacterize distributions as wages, you'll have a better chance against the IRS if you set a consistent wage for the whole year. Please contact our office for our help in evaluating your S-corporation officer wages to help keep the IRS off your back.