S-Corp Owner Salaries

What the IRS Expects and Why It Matters

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If you own an S-corp, you've probably thought about this: "Why should I pay myself a big salary when I can take distributions that avoid payroll taxes?" It's a logical question, and I've heard it countless times from business owners across every industry. The problem is, the IRS is thinking about it too—and they're a lot less sympathetic to the math.

After over 40 years of helping owners navigate tax strategy, I can tell you that S-corp salary decisions are one of the most audited and contentious areas of business taxation. And the stakes are real. I've watched smart, honest business owners face six-figure penalties because they didn't pay themselves a defensible salary. Let me walk you through what you need to know.

Why This Matters: The Structure of an S-Corp

Here's the fundamental issue. An S-corp is a pass-through entity—all income and losses flow through to your personal tax return. That part is favorable. But because of that structure, you play two roles simultaneously: you're both an employee AND a shareholder. And the IRS takes that distinction very seriously.

When you're an employee, your compensation is subject to Social Security and Medicare taxes (roughly 15.3% combined—the employer and employee shares together). When you're a shareholder, distributions aren't subject to those taxes. So naturally, owners want to minimize salary and maximize distributions. I get it. The math works in your favor.

The problem? The IRS expects you to pay yourself "reasonable compensation" for the work you actually do. That's not optional language—it's a legal requirement. And if they decide you didn't, they'll recharacterize your distributions as wages, hit you with back taxes, and pile on penalties that can exceed 100%.

How Big Is This Problem? The Numbers Tell the Story

In 2000, the IRS found approximately 440,000 single-shareholder S-corps where the owner paid themselves literally zero in salary. Zero. They took everything as distributions. That got the IRS's attention—and it's stayed there ever since.

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The reason the IRS cracks down so aggressively is because it's a clear mathematical arbitrage. If you can push income away from payroll taxes, you're saving roughly 15 cents on every dollar of income you divert. Multiply that across millions of businesses, and you're talking about real revenue loss for the government.

When the IRS recharacterizes distributions as wages, here's what happens: you owe the payroll taxes you didn't pay, and then you owe penalties on top of that. We're not talking 10–20%. I've seen cases where negligence penalties alone added another 20% to the bill.

A Real Case: The Watson Decision

Let me give you a concrete example from a case that made it all the way to federal court. A CPA running an S-corp took a $24,000 salary for the year. That's it. But he distributed $220,000 to himself.

The IRS said: "No. That doesn't pass the smell test." They recharacterized $175,000 of those distributions as wages. The owner went to court to fight it. And he lost. The court upheld the IRS position completely. His case is now precedent—and it's not an outlier. It's exactly the kind of situation the IRS has been systematically pursuing for two decades.

What made it so clear-cut? A CPA managing a practice generates significant income. The idea that such a professional should be compensated at only $24,000 annually while extracting $220,000 in the same year doesn't reflect economic reality. The court looked at the numbers and called it what it was: aggressive tax avoidance.

How the IRS Determines "Reasonable Compensation"

So how do you figure out what's reasonable? The IRS has developed twelve specific factors they examine. If you're going to defend your salary decision, these are the metrics they'll evaluate:

- **The duties you perform** — What's your actual role in the business?
- **The volume of business you handle** — How much are you directly responsible for generating or managing?
- **The type of work and your responsibilities** — Are you managing operations, making major decisions, directly serving clients?
- **The complexity of your business** — Is this a simple service business or a complex multi-faceted operation?
- **Time and effort devoted** — How many hours do you actually work? Are you part-time or fully engaged?

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- **The timing and manner of bonuses** — Do you pay yourself bonuses consistently, or do they spike in certain years?
- **Whether you use a formal compensation formula** — Do you have documented policies for how compensation is determined?
- **The cost of living in your location** — Salaries vary significantly by geography and industry.
- **Your ability and achievements** — What's your experience level? What have you accomplished in your field?
- **Pay compared to gross and net income and distributions** — Does your salary represent a reasonable share of business profits?
- **The company's pay policy for all employees** — Are you compensating yourself fairly compared to other key staff?
- **Historical payment patterns** — Has your salary been consistent, or does it jump around?

These aren't arbitrary. They're designed to answer one question: "Does this person's compensation reflect what someone in their position would actually earn in a similar business?" If the answer is obviously no, you're vulnerable.

A Case Study in Specifics

I've mentioned that the IRS office actually has salary analysis software for various occupations. Let me show you how this works in practice. In one case, the IRS examined a CPA running a small firm in Arkansas. The IRS software indicated that a reasonable salary range for that position was $45,000 to $49,000 annually.

The owner was paying himself $22,000 and taking $180,000 in distributions. The IRS recharacterized approximately $20,000 of distributions as wages. It wasn't a complete audit disaster, but it cost money—in back taxes, interest, and penalties. More importantly, it caused enormous stress and tied up resources that could have been deployed elsewhere in the business.

That case illustrates something important: even when an adjustment isn't catastrophic, it's still expensive and disruptive. And it's completely avoidable with proper planning.

How to Set a Defensible Salary

So what should you do? Here's my practical guidance:

First, document your responsibilities. Write down what you actually do. Not what you theoretically do—what you actually spend your time on. This becomes your evidence if you're ever audited.

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Second, research comparable compensation. What would someone with your experience and responsibilities earn if they were an employee at a similar business? Industry associations, salary survey databases, and even IRS guidance on comparable positions can provide benchmarks. Don't guess. Get actual data.

Third, document your compensation methodology. Do you pay yourself a percentage of revenue? A formula based on profitability? A market-based salary? Whatever your approach, write it down and apply it consistently. Consistency is credibility.

Fourth, ensure your salary reflects economic reality. If your business generates $500,000 in profit and you take $30,000 in salary, that's probably not going to survive scrutiny. Your salary should reflect a reasonable portion of the value you create. A rule of thumb: many S-corp owners should be taking salary that represents 50–75% of what would be reasonable W-2 income, with the remainder taken as distributions.

Fifth, revisit this annually. As your business grows and your income increases, adjust your salary accordingly. Not making changes year after year when your business is expanding? That's another red flag to auditors.

The Bottom Line

I've guided many business owners through S-corp strategy, and this is always the toughest conversation. The tax savings from taking minimal salary are real—but the risk is also real, and it's concentrated.

The IRS can audit prior years, recharacterize your distributions as wages, assess penalties that exceed 100% of the underlying tax, and you'll lose in court if your salary decision doesn't reflect economic reality. I've seen it happen.

The good news? This is entirely avoidable. Pay yourself a reasonable salary—one that reflects your actual work, your responsibilities, and your market value. Take reasonable distributions on top of that. Document everything. This approach is defensible, sustainable, and still provides significant tax advantages over other business structures.

Your S-corp is a powerful tool. Use it wisely, and it'll serve you well for decades. Cut corners on the salary question, and you're betting against the IRS in a game where they have all the data and all the leverage.

Don't take that bet.

If you're not confident your salary structure would survive IRS scrutiny, that's worth a look.

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