How to Determine a Reasonable Salary From Your S-Corp

S-Corps offer big tax benefits, but you *must* pay yourself a "reasonable salary" if you provide services. So what's considered reasonable—and how do you figure it out?

Why It Matters

Getting your salary right is crucial. Too **low** and the IRS might reclassify distributions as wages (back taxes + penalties). Too **high** and you lose key tax benefits—paying more payroll tax than needed, reducing your Qualified Business Income (QBI) deduction, and hurting your Pass-Through Entity Tax Election (PTET).

Where to Start: 3 Key Factors

1. **The Job Performed** – The type of work you do sets a baseline. Specialized, highly skilled roles (like a surgeon or software engineer) demand higher salaries than manual or entry-level work (like a house painter or administrative assistant). Think about the level of education, certification, and risk involved in your job.
2. **Geography** – Location has a big impact. Cost of living and market rates vary widely across the country. A CPA in San Francisco will command a higher salary than one in rural Iowa, even if they're doing the same work.
3. **Profitability** – Your company's financial performance also factors in. Even if the standard pay for your role is high, the IRS won't expect you to pay yourself more than what your business can reasonably support. For example, if your medical practice typically pays $300k, but you only cleared $50k in profit this year, a lower salary may still be acceptable—especially if you can document limited distributions or tight cash flow.

What the IRS Looks At

There's no IRS formula—but they do consider a wide range of factors that collectively paint a picture of what your salary *should* be:

- **Your experience, duties, and time commitment** – The more qualified and involved you are, the higher your expected compensation.
- **Profitability and dividend history** – If your business is doing well financially, a higher salary might be justified (and expected).

- **What similar businesses pay** – Benchmarks matter. If someone in your role at a comparable business earns more, your salary might be scrutinized.
- **Bonus structures and compensation plans** – These help show consistency and planning in your compensation strategy.
- **Wages paid to other employees** – If your staff earns close to what you do—or more—it raises questions about whether you're underpaying yourself.

Ultimately, the IRS wants to know: what would you have to pay someone else to do your job, with your level of skill, responsibility, and time investment? That's your anchor point for setting a reasonable salary.?

Three Methods to Calculate Salary

1. **Market Approach** (most common)
   - This method evaluates what others in your industry and region earn in similar roles. Think of it as salary benchmarking. It's the most objective of the three because it uses real-world compensation data to support your pay level. If your salary is in line with your peers, it provides strong justification.
2. **Income Approach**
   - This considers what a third-party investor would deem an acceptable return on their investment. If your salary is low but profits are extremely high, that might indicate you're taking more income as distributions to avoid payroll taxes. The IRS sees unusually high returns as a red flag.
3. **Cost Approach**
   - This method breaks your work down into specific tasks. You estimate the time spent on each duty, then apply a market rate to calculate a total "replacement cost" for your role. While accurate, it can be time-consuming and subjective, especially when self-reporting your tasks.

Each method has strengths and limitations, but the IRS generally gives the most weight to the Market Approach because it's based on observable market data. The other two are useful for refining or supporting your salary analysis.

What Happens If You Underpay?

IRS can reclassify distributions as wages:

- **Joseph Grey Case** – Paid no salary; IRS reclassified all distributions as wages.
- **David Watson Case** – Paid himself $24k while taking ~$200k in distributions. Court said $91k was a reasonable salary.

Overpaying Isn't Smart Either

Overpaying means unnecessary payroll taxes *and* less QBI deduction/PTET benefits. For example:

- A client paid themselves $80k in a year the business lost $80k—costing ~$12k in payroll taxes for no gain.

Profit Is the Ceiling

The IRS won't ask you to pay a salary **higher than your business's profit**. If you make $50k, that's your max exposure—even if others in your profession earn $500k.

When Courts Side With Taxpayers

Occasionally, courts rule in favor of the taxpayer:

- **Sean McAlary Case** – IRS wanted to assign a $100k salary, but court settled on $83k.
- **Davis Case** – IRS tried to call loan repayments wages; court reduced IRS's $39k assessment to $647.
- **Goldsmith Case** – Despite poor records, court ruled many payments were returns of capital, not wages.

These are *exceptions*, not the rule. Most cases favor the IRS.

Final Thoughts

This stuff is *dense*, but important. Work with your CPA to determine a well-justified salary. Too low—or too high—can cost you thousands.

And remember: a reasonable salary is not just a compliance checkbox—it's a tax strategy.
