DAVID K. MCCOY

CERTIFIED PUBLIC ACCOUNTANT

# Reasonable Compensation of Shareholders and Officers

A deduction is allowed for compensation, but the amount must be reasonable and the payment must be solely for services. (IRC §162(a); Treas. Regs. §1.162-7(a)) The Ninth Circuit uses five factors to determine the reasonableness of compensation:

1. The employee's role in the company;
2. Comparison of compensation paid by similar companies for similar services;
3. The character and condition of the company;
4. Potential conflicts of interest; and
5. Internal consistency of compensation arrangements

Both C corporations and S corporations might be tempted to pay unreasonable compensation, but they are the flip sides of each other. C corporations might be tempted to pay unreasonably high compensation to its shareholder-employees to avoid paying nondeductible dividends. On the other hand, S corporations might be tempted to use unreasonably low compensation to avoid employment taxes.

In the case of S corporations, the IRS lists the following factors in determining the amount of reasonable compensation:

- Training and experience;
- Duties and responsibilities;
- Time and effort devoted to the business;
- Dividend history;
- Compensation to non-shareholder employees;
- Timing and manner of paying bonuses to key employees;
- What comparable businesses pay for similar services;
- Compensation agreements; and