Determine a reasonable salary for a corporate business owner

If you're the owner of an incorporated business, you probably know that there's a tax advantage to taking money out of a C corporation as compensation rather than as dividends. The reason is simple. A corporation can deduct the salaries and bonuses that it pays executives, but not its dividend payments. Therefore, if funds are withdrawn as dividends, they're taxed twice, once to the corporation and once to the recipient. Money paid out as compensation is taxed only once, to the employee who receives it.

However, there's a limit on how much money you can take out of the corporation this way. Under tax law, compensation can be deducted only to the extent that it's *reasonable*. Any unreasonable portion isn't deductible and, if paid to a shareholder, may be taxed as if it were a dividend. The IRS is generally more interested in unreasonable compensation payments made to someone "related" to a corporation, such as a shareholder or a member of a shareholder's family.

How much compensation is reasonable?

There's no simple formula. The IRS tries to determine the amount that similar companies would pay for comparable services under similar circumstances. Factors that are taken into account include:

- The duties of the employee and the amount of time it takes to perform those duties;
- The employee's skills and achievements;
- The complexities of the business;
- The gross and net income of the business;
- The employee's compensation history; and
- The corporation's salary policy for all its employees.

There are some concrete steps you can take to make it more likely that the compensation you earn will be considered “reasonable,” and therefore deductible by your corporation. For example, you can:

- Use the minutes of the corporation’s board of directors to contemporaneously document the reasons for compensation paid. For example, if compensation is being increased in the current year to make up for earlier years in which it was low, be sure that the minutes reflect this. (Ideally, the minutes for the earlier years should reflect that the compensation paid then was at a reduced rate.)
- Avoid paying compensation in direct proportion to the stock owned by the corporation’s shareholders. This looks too much like a disguised dividend and will probably be treated as such by IRS.
- Keep compensation in line with what similar businesses are paying their executives (and keep whatever evidence you can get of what others are paying to support what you pay).
- If the business is profitable, be sure to pay at least some dividends. This avoids giving the impression that the corporation is trying to pay out all of its profits as compensation.

Planning ahead can help avoid problems. Contact us if you’d like to discuss this further.