

Reasonable Shareholder Salary



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One of the biggest headaches of electing to be taxed as an S Corp is calculating a reasonable shareholder salary. Once you elect S Corp status, the IRS requires all shareholders to pay themselves a reasonable officer compensation. You will want this salary to be on the lowest end of reasonable so you aren't paying additional, unnecessary payroll taxes (Social Security and Medicare taxes). But too low, and the IRS will deem it unreasonable. Ok... cool, so how in the world do you figure out what that perfect number is? This post will focus primarily on RCREports easing this S Corp salary headache.

What Is Reasonable Officer Compensation

So, you've decided electing S Corp status is the right move for your business and now you're hearing about all the fun surrounding calculating a reasonable shareholder salary. Is using the word "fun" a reach...sure, but why not keep it positive? The IRS published **Fact Sheet 2008-25** which gives very "clear" guidelines on what a reasonable shareholder salary should be. It reads-

There are no specific guidelines for reasonable compensation in the Code or the Regulations. The various courts that have ruled on this issue have based their determinations on the facts and the circumstance of each case.

Crystal clear, right? How about the several tax court cases?

- Ulrich v. United States, 692 F. Supp. 1053 (D. Minn., 1988)
- **Spicer Accounting v. United States, 918 F.2d 90 (1990)**
- **Watson v. Commissioner, 668 F.3d 1008 (8th Cir. 2012)**
- JD & Associates, Ltd. v. United States, No. 3:04-cv-59 (District Court, North Dakota, 2006)
- Davis v. United States, 1994 U.S. Dist. LEXIS 10725 (District Court, Colorado, 1994)
- **Sean McAlary Ltd. Inc. v. Commissioner (Tax Court Summary Opinion 2013-62)**
- Label Graphics, Inc. v. Commissioner, Tax Court Memo 1998-343
- Brewer Quality Homes, Inc. v. Commissioner, Tax Court Memo 2003-200,
- Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315 (5th Cir. 1987)

Still doesn't help, does it?

Okay, our apologies, you're reading this post to find real answers to the reasonable shareholder salary argument so let's break it

down! We've been computing reasonable salaries at WCG (formerly Watson CPA Group) since 2007, and we believe to find the sweet spot every time! One of the best tools we use is RReports.

RReports - How to Find Your Perfect Number

What may seem like a daunting task can become a breeze by utilizing a company called RReports (or Reasonable Compensation Reports). **RReports** is a Denver-based consulting firm that uses a survey, completed by you, to synthesize a blend of IRS criteria, court rulings, geographic data, and their exclusive database of wages to accurately assess a reasonable shareholder salary. Their defensible reports have been used over and over again in various federal cases and tax court litigations, including business valuation disputes.



RReports uses three methodologies to generate a report: Cost Approach, Market Approach, and Income Approach. The Market Approach and the Income Approach are used for bigger companies or for businesses where there isn't much data available to compare. The Cost Approach, aka the Many Hats Approach, is the one we see most commonly used for small, one-person or two-person, S Corps.

The Cost Approach analyzes the many duties a business owner completes and how much time is spent performing each task. It then determines a comparable wage for each duty and adds them up for a total cost to replace the services of the business owner. As a small business owner, you have to wear many hats; sometimes you're the janitor, human resources, IT, etc. RReports assigns a number to each task you perform and builds you up brick-by-brick until they determine a final salary of what it would cost to replace you and everything you bring to the S corporation.

The RReports process is very easy! RReports sends you a link to complete a survey, you complete it, and it calculates what your reasonable shareholder salary should be! Bada-Bing-Bada-Boom! The survey begins by asking you

- where you are located (state and county),
- how many hours you work every week,
- what standard tasks you do for your business (janitorial, administrative, marketing, finance, etc.), and
- what business specific tasks you do.

If you find it hard to describe your line of work, do not worry! They have a full alphabetized list of business specific tasks that you can pick from! It then asks you to break down how much time you spend on the standard tasks and the business specific tasks and asks you to rate your proficiency. After all those questions are answered, RReports generates a 7-8 page report with colorful graphs, real court rulings, and a business breakdown that explains how they came up with that final number. YAY! Here is a **sample report** for your viewing pleasure. After considering factors like health insurance, HSA and HRA, or a 401K, we massage the numbers for you and adjust the recommended salary.

This is such a great tool to use because just in case the IRS comes knocking at your door, questioning where you got your numbers from, you have 7-8 pages that explain exactly that! Now the burden shifts to the IRS to deem your calculation unreasonable... and for lack of better data, the IRS is commonly relegated to using your number.

Calculating a reasonable shareholder salary is not easy, so feel free to reach out to us, watch our **reasonable salary video**, or visit our **S Corp Salary** page dedicated to this topic for more information. Becoming an S Corp has many benefits but navigating the S Corp world can be difficult, let us help! *Latesha Anderson is part of the Business Development team for WCG (formerly Watson CPA Group), a business consultation and tax preparation firm located in Colorado Springs.*