GUIDE

S-Corp reasonable salary: how to set yours

If you work in your S-Corp, the IRS expects you to pay yourself a reasonable salary through payroll before taking distributions. Reasonable means roughly what the business would pay someone else to do your job. There's no fixed percentage. You find the number from wage data for your role, then write down how you got there.

QUICK FACTS

- **Who.** Shareholders who work in the business
- **Paid.** Through payroll, with a W-2
- **Benchmark.** What you'd pay someone else for your work
- **Not a rule.** The 60/40 split you'll read about online
- **Too low.** Distributions can be recast as wages

Why does the salary matter so much?

Salary carries Social Security and Medicare tax, 15.3% in total split between you and the company, up to the 2026 wage base of $184,500. Distributions don't. So every dollar moved from salary to distributions saves payroll tax, and that's exactly why the IRS watches the split. Pay yourself too little and you're avoiding employment tax. Pay yourself too much and the S-Corp stops saving you anything.

What does the IRS look at?

The IRS lists the factors courts have used to decide what's reasonable:

- Your training and experience
- Your duties and responsibilities
- The time and effort you put into the business
- The company's dividend and distribution history
- What it pays employees who aren't owners
- When and how bonuses are paid
- What comparable businesses pay for similar services
- Any compensation agreements or formulas you use

General information, not tax advice for your situation.

No single factor decides it. The question underneath all of them is simple. If you weren't the owner, what would this business have to pay to get your work done?

How do you find the number?

METHOD	HOW IT WORKS	BEST FOR
Market	Look up what employees in your role earn in your area, using Bureau of Labor Statistics wage data or industry surveys	Owners with one clear job, like a consultant, designer or nurse practitioner
Many hats	Split your time across roles, like 50% technician, 30% manager, 20% bookkeeper, and price each part at its market rate	Owners who run the business and do the work
Income	Start from profit and work out what return an investor would expect from the business, with the rest attributed to your labor	Businesses with significant equipment, staff or capital

Most small business owners use the market or many-hats method. For a solo consultant whose clients pay for their expertise, the salary usually lands close to the market wage for that role. For a shop owner with five employees, a lot of the profit comes from other people's work and the capital in the business, which supports a lower share as salary.

What happens if your salary is too low?

The IRS can reclassify distributions as wages and assess the payroll tax that should have been paid, plus penalties and interest. In *Watson v. United States*, decided in 2012, an S-Corp owner took a $24,000 salary alongside much larger distributions. The court reset the wages to about $91,000 a year for the years in question, with back employment taxes and penalties. Courts have backed the IRS in cases like this for decades.

A zero salary is the hardest to defend. If you're working in the business and taking money out, some salary is expected.

What if the business isn't profitable yet?

The rule follows the money. If the company has little profit and you aren't taking distributions, a low salary, or none, can be defensible for that period. Once you start taking cash out, salary should come first. We set it up so payroll starts when the money does.

What else does the salary change?

- **Retirement savings.** A Solo 401(k) employer contribution is up to 25% of your W-2 wages, so a very low salary limits what you can put away.
- **The QBI deduction.** Your salary isn't qualified business income, so a higher salary lowers the 20% deduction a little.

- **Health insurance.** Premiums the company pays for a more-than-2% owner go on your W-2. They're not subject to Social Security or Medicare tax when paid under a plan, and you can usually deduct them on your personal return.
- **Social Security benefits.** Your future benefit is based on wages, so a lower salary means smaller credited earnings.

How should you document it?

Write a short memo each year. Your role and hours, the wage data you used with its source and date, the method, and the number you chose. Keep it with the year's payroll records. If the IRS ever asks, a dated memo showing how you got to the number carries far more weight than a figure picked after the fact. Revisit it when the business changes, like when you hire, raise prices or step back from the day-to-day work.

Want a plan for this year?

We run your numbers and show you the options. Book a free 30-minute call at eminenttax.com/contact or call (972) 347-4590.

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General information, not tax advice for your situation.