

BONUS GUIDE

5 Things the IRS Looks for in S-Corp Compensation



What every S-Corp owner needs to know to document compensation and reduce audit risk

Paired with the S-Corp Owner Compensation Planning Workbook

Bovay Tax Services LLC
Tax Preparation | Payroll | S-Corp Strategy | Advisory

How to Use This Guide

This guide identifies the 5 most common IRS red flags in S-Corp compensation — and what to do about each one. Use it alongside the S-Corp Owner Compensation Planning Workbook to document your salary decision and reduce audit exposure.

This is an educational resource, not tax advice. All compensation decisions should be reviewed by a qualified CPA or Enrolled Agent.

Red Flag #01

Paying Yourself \$0 — Or a Salary Far Below Market

What the IRS Looks For

The IRS's most-cited S-Corp enforcement issue is owners who pay themselves little or nothing in W-2 wages while taking large distributions. The IRS has successfully reclassified these distributions as wages in dozens of Tax Court cases, resulting in back payroll taxes, penalties, and interest.

Common Warning Signs

- W-2 salary of \$0 or under \$10,000 when the business generates significant profit
- Distributions that dwarf W-2 wages with no clear justification
- Salary that has remained flat for years while profit has grown

What To Do

Set a W-2 salary that reflects what you would pay a third party to perform your role. Use the Role & Duties Worksheet (Tab 5 of the Workbook) to document your analysis. A salary in the range of 35–60% of S-Corp net profit is a common starting benchmark — but market rate research is more defensible than any formula.

■ IRS Reference: IRS Fact Sheet FS-2008-25 — Wage Compensation for S Corporation Officers

Red Flag
#02

No Documentation of How Salary Was Determined

What the IRS Looks For

The IRS expects S-Corp owners to be able to explain how they arrived at their salary. A salary that appears to be chosen to minimize FICA taxes — with no supporting research or rationale — is a significant audit red flag, regardless of the dollar amount.

Common Warning Signs

- No salary research on file (no BLS data, no Glassdoor printout, no survey)
- No written compensation agreement or board resolution
- No annual review process — salary set once and never revisited

What To Do

Document your process. Print the BLS Occupational Employment Statistics page for your role. Save Glassdoor or LinkedIn Salary screenshots. Use the Annual Documentation Log (Tab 4 of the Workbook) to create a year-by-year record. A written board resolution approving the compensation decision adds significant credibility.

■ **Best Practice:** IRS agents look for contemporaneous records — documentation created at the time of the decision, not reconstructed after the fact.

Red Flag
#03

Health Insurance Premiums NOT Included on W-2 Box 1

What the IRS Looks For

S-Corp owners who pay for their own health insurance must have those premiums included in W-2 Box 1 wages to claim the self-employed health insurance deduction on Form 1040. This is one of the most commonly missed S-Corp requirements — and the IRS has specific guidance making it a compliance priority.

Common Warning Signs

- Health insurance premiums paid by the S-Corp but not reported on the W-2
- Owner claiming the self-employed health insurance deduction without W-2 inclusion
- Premiums reported on K-1 instead of W-2 (incorrect treatment)

What To Do

Work with your payroll provider to ensure health insurance premiums are added to W-2 Box 1 (included in taxable wages) but excluded from Box 3 and Box 5 (not subject to Social Security / Medicare). The deduction is then claimed on Schedule 1 of the owner's personal 1040. This step cannot be corrected after year-end.

■ **IRS Reference:** IRS Notice 2008-1 — Self-Employed Health Insurance Deduction for S-Corporation Shareholders

Salary That Doesn't Reflect ALL the Roles You Perform

What the IRS Looks For

Many S-Corp owners set their salary based on one job title — typically their primary service role. But the IRS expects compensation to cover all the work the owner performs, including CEO, sales, operations, bookkeeping, HR, and more. Under-valuing support roles underestimates true reasonable compensation.

Common Warning Signs

- Salary benchmarked to one role when the owner performs 4–6 different functions
- No time-split analysis to account for multiple job duties
- Salary only benchmarked to the lowest-paid role performed

What To Do

Use the Role & Duties Worksheet (Tab 5 of the Workbook) to list every significant role you fill, estimate the percentage of your time spent in each, and research a market salary for each role. The blended result — percentage of time × market salary for each role — is one of the most defensible compensation methodologies available. This is the method used by professional compensation consultants in RCReports and similar tools.

■ **Pro Tip:** Most solo S-Corp owners should benchmark at minimum: CEO/management, primary service delivery, and sales/business development.

Failing to Adjust Salary as Business Income Changes

What the IRS Looks For

Reasonable compensation is not a one-time decision — it's a living analysis. The IRS views a salary that never changes as evidence it was set for tax reasons, not business reasons. As profit grows, compensation should generally grow with it. Keeping a flat salary in a growing S-Corp is an increasingly common audit trigger.

Common Warning Signs

- Same W-2 salary for 3 or more years regardless of business growth
- Distributions increasing year-over-year while salary stays flat
- No annual payroll review process in place

What To Do

Review your reasonable compensation at least once per year — ideally at the start of Q4 when you can still adjust payroll before year-end. Use Tab 1 of the Workbook to re-run your salary range estimate each year. Update your Documentation Log (Tab 4) with a note on why salary was kept the same or adjusted. Even a small documented review is far better than no review at all.

■ **Best Practice:** Set a recurring calendar reminder each October to review officer compensation before year-end payroll deadlines.

Ready to Document Your Compensation Decision?

Open the S-Corp Owner Compensation Planning Workbook to run your salary range estimate, score your IRS audit risk, and create an audit-ready documentation record — all in one place.

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This guide is provided for educational purposes only and does not constitute tax advice, legal advice, or a formal compensation analysis. S-Corp reasonable compensation is a facts-and-circumstances determination. Always consult a qualified CPA or Enrolled Agent before making payroll or compensation decisions for your S-Corporation.