



Wage Compensation for S Corporation Officers

FS-2008-25, August 2008

Corporate officers are specifically included within the definition of employee for FICA (Federal Insurance Contributions Act), FUTA (Federal Unemployment Tax Act) and federal income tax withholding under the Internal Revenue Code. When corporate officers perform services for the corporation, and receive or are entitled to receive payments, their compensation is generally considered wages. Subchapter S corporations should treat payments for services to officers as wages and not as distributions of cash and property or loans to shareholders.

S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates.

The Internal Revenue Code establishes that any officer of a corporation, including S corporations, is an employee of the corporation for federal employment tax purposes. S corporations should not attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages.

This fact sheet clarifies information that small business taxpayers should understand regarding the tax law for corporate officers who perform services.

Who's an employee of the corporation?

Generally, an officer of a corporation is an employee of the corporation. The fact that an officer is also a shareholder does not change the requirement that payments to the corporate officer be treated as wages. Courts have consistently held that S corporation officer/shareholders who provide more than minor services to their corporation and receive or are entitled to receive payment are employees whose compensation is subject to federal employment taxes.

The Treasury Regulations provide an exception for an officer of a corporation who does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration. Such an officer would not be considered an employee.

What's a Reasonable Salary?

The instructions to the Form 1120S, U.S. Income Tax Return for an S Corporation, state "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

The amount of the compensation will never exceed the amount received by the shareholder either directly or indirectly. However, if cash or property or the right to receive cash and property did go the shareholder, a salary amount must be determined and the level of salary must be reasonable and appropriate.

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 circumstances of each case.

Some factors considered by the courts in determining reasonable compensation:

- Training and experience
- Duties and responsibilities
- Time and effort devoted to the business
- Dividend history
- Payments to non-shareholder employees
- Timing and manner of paying bonuses to key people
- What comparable businesses pay for similar services
- Compensation agreements
- The use of a formula to determine compensation

Medical Insurance Premiums treated as wages.

The health and accident insurance premiums paid on behalf of the greater than 2 percent S corporation shareholder-employee are deductible by the S corporation as fringe benefits and are reportable as wages for income tax withholding purposes on the shareholder-employee's Form W-2. They are not subject to Social Security or Medicare (FICA) or Unemployment (FUTA) taxes. Therefore, this additional compensation is included in Box 1 (Wages) of the Form W-2, Wage and Tax Statement, issued to the shareholder, but would not be included in Boxes 3 or 5 of Form W-2.

A 2-percent shareholder-employee is eligible for an AGI deduction for amounts paid during the year for medical care premiums if the medical care coverage is established by the S corporation. Previously, "established by the S corporation" meant that the medical care coverage had to be in the name of the S corporation.

In Notice 2008-1, the IRS stated that if the medical coverage plan is in the name of the 2percent shareholder and not in the name of the S corporation, a medical care plan can be considered to be established by the S corporation if: the S corporation either paid or reimbursed the 2percent shareholder for the premiums and reported the premium payment or reimbursement as wages on the 2percent shareholder's Form W-2.

Payments of the health and accident insurance premiums on behalf of the shareholder may be further identified in Box 14 (Other) of the Form W-2. Schedule K-1 (Form 1120S) and Form 1099 should not be used as an alternative to the Form W-2 to report this additional compensation.

Page Last Reviewed or Updated: 03-Aug-2012