

# Closely-Held Companies Should Use Care When Setting Compensation of Stockholder-Employees

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February 20, 2024

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**PRACTICES** Employee Benefits and Executive Compensation

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When setting employee compensation, companies are permitted to deduct a “reasonable allowance for salaries or other compensation for personal services” to their employees if the compensation is both (i) reasonable in its amount and (ii) paid by to the employee purely for personal services actually rendered by the employee. The determination of whether compensation is reasonable is based on all of the relevant facts and circumstances. If a company is a closely-held corporation that is paying salaries and bonuses to its stockholder-employees, the IRS also analyzes whether the company’s earnings that are paid to its stockholders as dividends are at a level that would satisfy an independent investor. If no or low dividends are paid, there is a risk that the IRS could deny the company’s deduction of compensation, arguing that the compensation otherwise paid to the stockholder-employee was not for their services, but instead, was just profits being paid to the stockholder-employee in the form of salary.

To minimize the risk that salary and bonuses paid to stockholder-employees may be recharacterized as dividends, closely-held businesses can take certain steps, including the following:

- Ensure that they have properly defined the stockholder-employee’s title and job description so that the title and job description accurately reflect the services that the stockholder-employee is providing;
- Determine the number of hours the stockholder-employee is working and make sure that the salary and bonus paid are equivalent to the salary and bonus paid to others in the company providing similar services (or if no one in the company provides such services, determine whether it is equivalent to the compensation paid by peer group companies for similar services provided in the company’s industry and market);
- Consider engaging an independent compensation consultant or advisor to review the company’s compensation paid to its stockholder-employees and to provide an opinion to the company regarding whether the compensation is consistent with market rates of pay;
- Annually evaluate whether dividends should be paid to stockholders based on the company’s profits determined without deduction of salaries and bonuses payable to stockholder-employees; and
- Maintain written documentation in the company’s files for each open tax year that supports the amount paid as salary and bonuses to the stockholder-employees as being reasonable.

While the foregoing steps may not prevent a challenge by the IRS of a closely-held corporation’s compensation paid to its stockholders-employees, by properly documenting why amounts were paid and maintaining records that support the company’s actions, the company will have a better ability to defend against any such challenge.