



Case Study:
Industry Rule-of-Thumb-vs-Defensible
Reasonable Compensation Analysis

Background

Dr. Lisa Nguyen, a successful independent chiropractor, operates her practice as an S-Corporation. Historically, Dr. Nguyen has determined her salary based on common industry “rule of thumb” guidelines—typically paying herself approximately 40% of practice net income. While this approach was straightforward, recent IRS scrutiny of S-Corp owner compensation practices raised concerns about potential underpayment of salary and risk of audit penalties.

Dr. Nguyen engaged a business advisory firm to help develop a **defensible reasonable compensation analysis** that aligns with IRS guidelines and supports her salary decisions with objective data and documentation.

Challenges

- **IRS scrutiny of S-Corp owner salaries:** The IRS expects owner-employees to receive a reasonable salary for services rendered, reflecting fair market value.
 - **Risk of penalties:** Underpaying salary and over-distributing profits as dividends can trigger audits and back taxes with penalties.
 - **Lack of documentation:** Salary decisions based on informal rules lack supporting evidence or analysis.
 - **Industry variability:** Wide variation in compensation benchmarks makes “rule of thumb” unreliable.
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Objectives

- Develop a defensible, data-driven reasonable compensation report for Dr. Nguyen’s salary.
 - Reduce audit risk by documenting salary determination methodology.
 - Align salary with comparable market data and practitioner responsibilities.
 - Educate Dr. Nguyen on ongoing compliance best practices.
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Step 1: Data Collection and Role Analysis

- Conducted detailed interviews with Dr. Nguyen to document her job duties, hours worked, and scope of practice.
- Collected financial data including practice revenue, net income, and historical compensation.
- Reviewed industry compensation surveys and databases specific to chiropractic professionals and healthcare S-Corp owners.

Step 2: Benchmarking Compensation

- Identified relevant compensation surveys from sources such as MGMA (Medical Group Management Association), APTA (American Physical Therapy Association), and industry salary databases.
- Adjusted benchmarks for geographic location, years of experience, practice size, and scope of services.
- Compared Dr. Nguyen's current salary to median and 75th percentile benchmarks.

Step 3: Reasonable Compensation Analysis Report

- Prepared a comprehensive report documenting:
 - Job description and responsibilities.
 - Market salary benchmarks and data sources.
 - Adjustments made for local market and practice specifics.
 - Recommended salary range based on data.
 - Explanation of how salary aligns with IRS reasonable compensation criteria.

Step 4: Implementation and Compliance Strategy

- Recommended adjusting Dr. Nguyen's salary to fall within the defensible range (approximately 55% of net income, slightly higher than prior).
- Established documentation protocols to maintain records of salary decisions, including periodic reviews and updated market data.
- Provided training on payroll compliance and tax reporting requirements.
- Suggested ongoing engagement with the advisory firm for annual salary reviews.

Results and Benefits

- **Reduced audit risk:** Dr. Nguyen now has a defensible, well-documented salary justification aligned with IRS expectations.
- **Improved compliance:** Clear methodology supports payroll tax reporting and reduces exposure to penalties.
- **Increased confidence:** Dr. Nguyen feels secure in her compensation decisions backed by objective data.
- **Financial clarity:** Adjusting salary improved retirement plan contributions and payroll tax planning.

Financial Illustration (Simplified)

Description	Prior Salary (40% of Net Income)	Recommended Salary (55% of Net Income)
Practice Net Income	\$300,000	\$300,000
Salary	\$120,000	\$165,000
Payroll Taxes (15.3%)	\$18,360	\$25,245
Remaining Distribution	\$180,000	\$135,000
Self-Employment Tax on Distribution	\$27,540 (risk if audited)	\$0 (S-Corp dividends not subject to SE tax)

Note: Higher salary increases payroll taxes but reduces risk of IRS reclassification and penalties.

Key Takeaways

- Relying on industry “rules of thumb” for owner compensation is risky and may invite IRS scrutiny.
- A defensible reasonable compensation analysis requires comprehensive data gathering, benchmarking, and documentation.
- Regularly updating compensation analysis ensures ongoing compliance with evolving IRS standards.
- Advisory support can help practitioners balance tax efficiency with audit risk management.

Frequently Asked Questions (FAQs)

Q: What factors determine reasonable compensation?

A: Job duties, hours worked, geographic location, experience, practice size, and comparable market data.

Q: How often should reasonable compensation be reviewed?

A: At least annually or when significant changes occur in the practice or market conditions.

Q: What documentation is recommended?

A: Written reports, salary surveys, job descriptions, meeting notes, and payroll records.

Q: Can salary be too high?

A: Yes, excessive salary may reduce tax efficiency; balance is key.

Conclusion

By shifting from informal salary benchmarks to a defensible reasonable compensation analysis, Dr. Nguyen strengthened her compliance posture, reduced audit risk, and gained clarity on her compensation strategy. This case underscores the importance of data-driven advisory services in supporting healthcare practitioners’ business decisions.