

Reasonable Compensation

Job Aid for IRS Valuation Professionals*

*(This Job Aid Can Also be Helpful to Revenue
Agents and Other IRS Field Personnel)

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**Developed by a Team of IRS Valuation Professionals
From the Large Business and International Division**

This Job Aid is current as of the original date of issuance only.



This Job Aid is not Official IRS position and was prepared for reference purposes only; it may not be used or cited as authority for setting any legal position.

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This Job Aid is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.

This Job Aid is a guide for [IRS Valuation Professionals](#) on the Reasonable Compensation issue in Not-for-Profit and For-Profit entities. The Reasonable Compensation issue is factually intensive and must be determined based on all relevant facts and circumstances. The [IRS Valuation Professional](#) must first develop all relevant facts and then use professional judgment in choosing appropriate comparables and computing reasonable compensation using applicable valuation approaches.

Although the specific target of this Job Aid is [IRS Valuation Professionals](#), the material in the Aid should be helpful to Revenue Agents and other IRS Field Personnel engaged in identifying and/or developing a Reasonable Compensation issue. It can provide guidance at the risk analysis stage and serve as a template for information collection and analysis.

Reasonable Compensation Job Aid

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SECTION I: PURPOSE, BACKGROUND AND CASE COORDINATION

PURPOSE

The purpose of this Job Aid is to assist [IRS Valuation Professionals](#) (Valuation Analysts) in their examination of Reasonable Compensation and to help them to better understand the available approaches. The Job Aid discusses the valuation methods currently used in determining Reasonable Compensation. These methods include the market approach, which is the most commonly used method; the income approach; and, finally, the least used method, the cost approach.

BACKGROUND

The Reasonable Compensation issue usually involves a determination of whether the amount of compensation paid is reasonable so that it is deductible under section 162 of the Internal Revenue Code for income tax purposes. In some cases, the Reasonable Compensation issue comes up when the amount of compensation paid may be lower than reasonable to avoid the payment of employment taxes.¹ For tax-exempt entities, the issue involves the application of section 4958, taxes on excess benefit transactions, and reflects a concern that excessively high compensation may unduly enrich officers, directors, trustees or key employees of the tax-exempt entity at the expense of the qualified charitable purpose.

The Tax Court first considered the "Reasonable Compensation" issue in 1917. Due to the factual nature of the issue, it remains a subject of considerable controversy. Thorough factual development is a key to analyzing the issue.

¹ According to Treas. Reg. § 1.162-7(a), "The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services."

Treas. Reg. § 1.162-7(b)(3) states, "[T]he allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."

The courts favor a "market approach" when determining Reasonable Compensation. Under this approach, the determination of the reasonableness of an employee's compensation is made by comparing the employee's compensation with the compensation of employees performing similar duties at similar companies. Ideally, the companies for comparison would be mirror images of the company being analyzed. Due to challenges in matching employees at comparable companies with those of the subject company and in obtaining relevant compensation information for those comparable employees, a number of other approaches have been developed to determine Reasonable Compensation.

CASE COORDINATION

Reasonable Compensation issues often require coordination and consultation within LB&I, and sometimes with other operating divisions and Counsel. Valuation Analysts should appropriately involve the Team Coordinator, Account Coordinator, Principal Revenue Agent, Employment Tax Specialist or other relevant team members in the issue development and/or in the risk analysis to assure that the issue is given a proper priority in accordance with the overall case examination. Conversely, if an audit team is considering a reasonable compensation issue, it is very important that a Valuation Analyst be consulted as part of the issue development. The Compensation and Benefits IPG Subject Matter Experts (SMEs) are available to provide technical assistance and guidance to aid in working through your Reasonable Compensation issues.

APPENDIX A provides a list of suggested readings on the subject of reasonable compensation determinations.

SECTION II: IDENTIFYING A REASONABLE COMPENSATION ISSUE

CAUTIONS

When first looking at this issue, there are some pertinent cautions and reminders:

- 1) Reasonable Compensation may be a sensitive issue. The Valuation Analyst's job is to develop the facts, apply appropriate valuation approaches, and compute the amount of compensation that is reasonable based on all facts and circumstances. Avoid personal judgments about what a specific individual's efforts seem to be worth to you.
- 2) The Valuation Analyst should use the term "reasonable" compensation when discussing this issue with the taxpayer. The Analyst's job is not to tell anyone how much an employee may be compensated. Rather, the Valuation Analyst's job includes addressing the U.S. Federal tax implications that only a reasonable amount is deductible as compensation.
- 3) The issue of Reasonable Compensation involves personal and sensitive information, which the Valuation Analyst should carefully protect.
- 4) What amount constitutes Reasonable Compensation might best be viewed as a range because of the interpretive nature of the issue. Based on the same facts, valuation experts may arrive at various amounts for Reasonable Compensation.
- 5) Sometimes, high compensation is indicated through comparing the subject's compensation to that of a commissioned salesperson. If the comparison is valid (i.e., company is in the same industry as the subject company and the subject's employee is actually doing sales work), then it may not be appropriate to take a position for a lower level of compensation.
- 6) It is important to conduct a thorough interview with the employee whose compensation is under examination. A good interview reveals the employee's experience, duties, knowledge, and responsibilities at the company. Failure to interview the employee may result in the taxpayer subsequently presenting facts that the Valuation Analyst did not get a chance to consider. If necessary, a Summons may be used to compel the employee to appear for an interview. An additional option (if needed) is to swear in the employee and prepare an Affidavit containing the employee's statement under oath.

WHERE REASONABLE COMPENSATION ISSUES ARE FOUND

Typical cases where Reasonable Compensation issues occur on tax returns are as follows:

1. FAMILY BUSINESSES

The Reasonable Compensation issue may arise in a family business. A typical scenario may involve a parent paying a child more than the reasonable worth for the child's services. The business claims a business tax deduction for what should be a gift to the child. The amount of compensation determined to be in excess of what is reasonable for the services actually performed may be disallowed as a deduction, whether the entity is a corporation, sole proprietorship, or partnership. In this instance, there also could be an Estate & Gift (E&G) Tax issue with respect to the excess compensation to a family member as an estate-planning tool.

2. CLOSELY HELD BUSINESSES

Reasonable Compensation issues may occur in closely held corporations where employees are also shareholders. A portion of the compensation may in reality be a dividend on stock if the employee is also an owner. This is advantageous to the taxpayer because compensation is a deductible business expense and dividends are not deductible. The income is taxable to the recipient regardless of its classification but different tax rates could apply depending upon the nature of the income.

3. SUBCHAPTER S CORPORATIONS

Compensation can be an issue with respect to a corporation that has elected to be taxed under the provisions of Subchapter S. If you have a single owner S corporation and disallow compensation deducted by the corporation, there will be no immediate income tax effect. If there is more than one owner then tax issues could arise as to the proper party or parties to which a disallowed compensation amount should be allocated. The more likely scenario is that a lesser amount will be identified as compensation in order to avoid paying payroll taxes with the remaining amount treated as owner distributions. In these cases, by determining what a proper level of compensation should be, a Valuation Analyst may make the appropriate allocation between amounts subject to payroll tax and amounts not subject to payroll tax.

4. FOREIGN CORPORATIONS

Any time there are foreign operations where wages and salaries are being paid, there can be compensation allocation issues under section 482. International examiners should be consulted on these types of issues.

5. ACQUISITIONS AND DIVESTITURES/SALES

In mergers and acquisitions occurring after August 10, 1993, taxpayers may attempt to avoid the 15-year amortization period under section 197 applicable to goodwill and certain intangibles. This may be done, for example, by drafting consulting and/or employment agreements involving large payment amounts that are effective for only a short period of time and that provide entity level deductions. These payment amounts are then carved out of the overall purchase price. Reasonable compensation determinations need to be made to make the proper allocation of purchase price.

6. ADJUSTMENTS PROPOSED FOR PRIOR YEARS COMPENSATION AMOUNTS

Sometimes poor financial conditions of a company in prior years may mean the company had to conserve capital and set its compensation levels accordingly. As the company's financial position improves, the company may argue that the officers need to be compensated at a higher level to make up for prior years' under-compensation. Generally, three requirements must be met under these circumstances for a taxpayer to deduct compensation in the current year:

- A. Taxpayer must establish the fact of the prior under-compensation.
- B. There must be a record of the contemporaneous intent to compensate for under-compensation in future years.
- C. The specific amount of the identified under-compensation must be stated.

7. LOANS – NO INTEREST, LOW INTEREST, DISGUISED COMPENSATION

Loans made by entities to its employees may be at no interest or at low interest and the terms may be such that the loan is, in fact, disguised compensation.

Loans to individuals exerting control in an entity should be scrutinized to determine if the loan terms are reasonable and are similar to what would be offered by unrelated third parties in the regular course of business. Some factors that are indicative of a bona fide loan include: the existence of a promissory note, cash payments required according to a specified repayment schedule, interest being charged, and security required for the loan in case of default. Beyond the existence of these factors a Valuation Analyst should determine if the loan provisions are indeed being followed and enforced. A Valuation Analyst should also look for loan forgiveness provisions for all or part of the loan. If a Valuation Analyst determines that a loan is a part of the employee's compensation, the amount of the loan must be included in the Reasonable Compensation analysis.

STEPS TO IDENTIFY REASONABLE COMPENSATION ISSUES

The steps listed below are intended to aid in assessing the magnitude of any Reasonable Compensation issue. From this analysis, it can be determined whether or not it would be a productive use of resources to develop the issue.

No single step is determinative; rather a Valuation Analyst should give consideration to all these items in assessing the issue.

1. PROCESS FOR SETTING COMPENSATION

Consider how compensation is determined in the organization. Is there a Compensation Committee or some other specific body charged with determining appropriate compensation levels and is it independent from the individual(s) whose compensation is being set? Is there a requirement for a higher level approval from an independent committee or body, for example, a company's officers or board of directors? Does the company keep contemporaneous records documenting the process for compensation determinations? Are salary surveys or comparables used to help in the determination of appropriate compensation based on an employee's job requirements, education, background, skill levels or other relevant factors? Are the employees for whom compensation is being set in a position to significantly influence the result of the process either directly or through related parties or persons with which they have other business relationships?

2. TAX RETURN INFORMATION

It is important to look at an employee's total compensation package. The following items may be considered compensation for Federal tax purposes, but may not be listed on an individual's W-2s:

- Automobile Allowance
- Awards/Prizes Over \$25 in Value (Gift Cards or Certificates in Any Amt.)
- Back Pay Awards
- Bonuses - Cash or Noncash
- Cafeteria Plan
- Commissions
- Company Owned or Leased Airplane
- Company Owned or Leased Cars
- Disability Payments
- Discount on Property or Services
- Educational Reimbursements
- Free or Subsidized Lodging
- Golden Parachute Payments
- Life Insurance Over \$50,000 in Value
- Low interest loans
- Meal Allowances and/or Reimbursements (when away from home overnight)
- Memberships in Athletic Facilities
- Mortgage, house insurance and Real Property taxes

- Moving Expenses/Relocation Allowances
- Nonqualified Stock Bonus Plan
- Partnership or S Corporation Distributions
- Pension and Profit Sharing Plans
- Nonqualified Stock Option Plan
- Reimbursements for Loss on Sale of Houses-Job Related Move
- Rent
- Severance Pay
- Scholarships/Fellowships
- Sick Payments
- Vacations (Free or Discounted)

Compensation may be reflected on an employee's tax return in various ways and appear in various line items. Compensation may be received in cash or property and may not be called salary. For example, besides officers' salaries, compensation has been listed under management fees, consulting fees, covenants not to compete, commissions, legal and professional fees, rent or housing expenses paid, and other. Also, one person's compensation may be listed under more than one account in the general ledger.

There may also be employment tax issues with respect to FICA and withholding on some of the items listed above if such are considered a part of the compensation. A referral to Employment Tax should be considered. A Reasonable Compensation issue that includes the adjustment of a pension and profit sharing deduction requires a referral to Employee Plans. On an individual tax return, Form 1040, look at Schedule C for large amounts of consulting fees, management fees, etc. that could signal a Reasonable Compensation issue for the payee entity.

3. NUMBER OF EMPLOYEES AT ISSUE

The people receiving the compensation must be identified. C-Corps (1120) with receipts over \$500,000 will provide a breakdown of officer's compensation on Schedule E, "Compensation of Officers." Note that this does not include compensation deducted elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction Simplified Employee Pension Plan (SEP) agreement. For tax-exempt entities, Form 990, Part VII, Section A, requires a listing of the compensation of officers, directors, trustees, key employees, other highly compensated employees and independent contractors. For other tax returns or non-officer compensation, the breakdown must be done through the initial interview and standard IDR requests. For example, an unusually large W-2 or 1099 may signal a Reasonable Compensation issue.

4. SALARY SURVEY COMPARISON

Do a comparison of the compensation with general salary surveys. Most salary surveys show a relationship between entity size and complexity and executive compensation. See APPENDIX B for a listing of general compensation surveys.

5. SALES COMPARISON

Look at overall officers' compensation compared to company sales. An issue may exist if the total officers' compensation is higher than the industry averages. As a broad indicator, Officers' Compensation as a percentage of Sales is usually less than 10% at the 90th percentile for a mid-sized or large, mature business. However, this number can vary considerably depending on the industry.

6. TAXABLE INCOME COMPARISON

Look at the taxable income on the tax return. Add back the compensation in question. Does it make a significant change in taxable income? For corporations, if most of the profit is taken out of the corporation in compensation, it may indicate a portion of the compensation is a disguised dividend. For tax purposes, Reasonable Compensation is an allowable expense while dividends are not allowed as an expense. Usually, Officers' Compensation divided by Taxable Income (Before NOLs) is less than 1.0 for a mid-sized or large, mature business but will depend on the overall size of the company and standard industry practices. Once again, treat this as a broad indicator and as part of your risk analysis. Officers' Compensation as a percentage of Sales, like Officer's Compensation as a percentage of Taxable Income, can vary considerably, depending on the industry. In general, smaller firms and privately-held firms tend to pay a higher percentage of income as officers' compensation than do larger, publicly-traded firms.

7. SUBORDINATES COMPARISON

Look at the relationships between the various salaries paid. For example, in many cases where compensation is independently set, the second in command will have total compensation of 50% to 80% of the CEO's total compensation. If the ratio is considerable lower than this, an issue may exist on the CEO's compensation.

8. OTHER SURVEY COMPARISONS.

Other compensation survey information may be available from the taxpayer or other sources. This information should be used in considering whether or not to develop an issue. See Section III of this Job Aid for additional information to request, as well as approaches to developing this issue.

SECTION III: DEVELOPING REASONABLE COMPENSATION ISSUES

Issue development consists of gathering facts and then analyzing these facts. Financial analysis as well as the standard approaches to performing a valuation (market, income, and cost) are presented here as a way of developing the issue. Determination of reasonable compensation is, at base, a standard valuation problem where what is being valued is an employee's services and the attributes that he or she brings to a company.

WHAT IS REASONABLE COMPENSATION?

Issue development begins with an understanding of what is compensation and what is reasonable compensation. Reasonable Compensation is defined by Treas. Reg. § 1.162-7(b)(3) as the **amount that would ordinarily be paid for like services by like organizations in like circumstances, and this standard is adopted in Treas. Reg. § 53.4958-4(b)(1)(ii)(A)**. Thus, the concept has two prongs:

Amount Test – focuses on the reasonableness of the total amount paid; and
Purpose Test – examines the services for which the compensation was paid.

Usually, courts only need to examine the first prong because the inquiry of whether the compensation was reasonable in most instances will subsume the compensatory intent inquiry. However, in some cases, an otherwise reasonable compensation payment may contain a disguised dividend requiring a compensatory intent inquiry apart from the reasonableness inquiry. While noting this “intent is subjective and difficult to prove,” *O.S.C. & Assocs. v. Commissioner*, 187 F.3d at 1116, 1120 (9th Cir. 1999), the Ninth Circuit affirmed the Tax Court decision. In this case, the Tax Court disallowed deductions for amounts paid under an incentive contingent compensation contract, without reaching the question of reasonableness, because of the “overwhelming evidence” that the corporation intended to distribute profits rather than pay compensation for services.

EVALUATING THE REQUIREMENTS OF SECTION 162

The reasonableness of compensation paid is a question of fact and each case turns on its own facts and circumstances. In addressing the Reasonable Compensation issue, a Valuation Analyst should consider the following factors (among others that may be relevant in a particular case):

- the employee's qualifications
- the nature, extent, and scope of the employee's duties;
- the employee's background and experience;

- the employee's knowledge of the business;
- the size and complexity of the business;
- the time devoted by the employee to the business;
- the economic conditions generally and locally;
- the character and amount of responsibility of the employee;
- whether or not the compensation is pre-determined based on activities to be performed or not determined until the end of the tax year;
- amounts paid to the employee in prior years;
- the salary policy of the taxpayer as to all employees; and
- the amounts paid by similar size businesses in the same area to equally qualified employees for similar services.

These factors are suggested by the provisions of the statute and the associated regulations and have been fleshed out over the years in numerous court decisions. See *Mayson Manufacturing Co. v. Commissioner*, 178 F.2d 115 (6th Cir.1949), See also *Owensby & Kritikos, Inc., v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987).

FACTORS RELATING TO THE EMPLOYEE

Arm's Length Relationship

This factor is one of the most important ones in evaluating the reasonableness of compensation. A determination must be made as to whether the employer and employee negotiated the compensation at arm's length. If the negotiation was at arm's length, the risk of excessive compensation is lower. If the negotiation was not at arm's length, the risk of excessive compensation is higher and further factual development may be needed to establish the potential presence of a Reasonable Compensation issue.

Control by Related Parties

It must be determined whether related parties exercise control over the company and, if so, whether the existing relationships are improperly influencing compensation amounts to certain employees. This element is often present in cases involving excessive compensation.

Availability of Comparable Services from a Third Party

Even if the employer could have obtained comparable services at a lower rate from someone other than the employee in question, this factor must then be considered further. The Valuation Analyst's determination must focus on whether the amount paid to the employee is nonetheless reasonable. This factor often is closely related to a lack of arm's length transaction.

Nature of Employee's Duties

The employee's duties are an important factor in determining reasonableness of compensation. If the employee performs highly specialized and skilled tasks, has responsibility for a large volume of work, and/or supervises other employees, he or she may command a higher salary.

Employee's Background and Experience

If an employee is particularly well-qualified for a position because of relevant prior experience, education, or proven expertise in the area, a higher salary might be warranted.

Time Devoted to Job

How much time does the employee devote to the job? Is it the employee's only job? Does the job require an extraordinary commitment of time? On the other hand, does the employee have other jobs that restrict the amount of time available for the position under analysis?

Earning History of the Employee

A large increase to an employee's compensation may indicate unreasonable compensation unless the duties of the employee changed significantly

FACTORS RELATING TO THE ORGANIZATION

Salary Scale of Others in the Same Line of Business

In general, more complex businesses need to pay higher compensation to attract properly qualified personnel. Treas. Reg. § 1.162-7(b)(3) states that, "[i]t is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."

Size of the Organization

A larger organization may pay a higher salary to its employees in reflection of the greater number and difficulty of tasks.

Salary Scale for Employees Generally

Disproportionately high salaries to certain persons may indicate the potential for that compensation to be unreasonable.

FACTORS RELATING TO THE COMPENSATION ITSELF

Criteria for Compensation

An organization's governing body should establish definite criteria for an employee's compensation, clearly spelling out the person's duties, responsibilities and measures of success in the position.

Salary Fixed Many Years in Advance

One indication that a salary reflects an employee's control over an organization rather than his or her work is that his compensation was established far in advance of the actual performance of services.

Substantiation of Duties Performed and Salary Paid

An organization should keep records indicating the duties performed by its employees and the hours those employees worked. The records will be particularly important if the organization seeks to justify compensation that appears unreasonable based solely on the amount involved.

Contingent Compensation

Treas. Reg. § 1.162-7(b)(2) states that the form of compensation does not determine its appropriateness. In section 162 cases, the courts have focused heavily on the concept of the employee's value to the organization in evaluating the reasonableness of contingent compensation. Although the cases involving tax-exempt organizations do not expressly embrace the section 162 analysis of contingent compensation, the reasoning of the cases is quite similar. The focus should be on whether the form of compensation is based on a real and discernible business purpose for the organization.

Evidentiary Issues

Companies have the burden of showing that compensation is reasonable. The courts do not draw an adverse inference from the Service's failure to offer evidence of comparables. However, it is often risky for the IRS to go forward based only on subjective arguments concerning reasonableness. Data on comparability generally requires expert testimony explaining its relevance before it will be given weight by the courts.

FACTUAL DEVELOPMENT

The facts must be thoroughly developed before a Reasonable Compensation issue is raised. Information can be requested by Information Document Request (IDR) or in an interview with the taxpayer. In addition to a functional analysis of the role of the employee in the business, development of the issue also includes conducting a functional analysis of the taxpayer's business, identifying competitors during the interview, and analyzing both the competitor's and taxpayer's businesses in-depth in order to get reasonable and valid comparisons.

APPENDIX C provides sample IDRs. The sample IDRs are intended as a tool for gathering the facts and developing the issue. One or more IDRs may be issued. Examiners should customize IDRs based on the specific facts of the case under examination.

If working with an LB&I Agent, it should be emphasized that they are responsible for meeting the requirements for issuing IDRs as contained in the LB&I Commissioner's directive issued on November 4, 2013 and effective on March 3, 2014.

FACTORS TO CONSIDER

The courts have developed a number of factors to be considered when determining Reasonable Compensation. For simplicity, these factors can be summarized under five areas.

1. Employee's role in the company.
2. External comparison of the employee's salary with those paid by similar companies for similar services.
3. Character and condition of the company.
4. Conflict of interest in relationship of the employee to the corporation.
5. Internal consistency in the company's treatment of payments to employees.

The above factors should be carefully considered when developing the issue.

See, for example, *Rapco Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996) where the court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue and *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987) where the court also agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue.

FINANCIAL ANALYSIS

Many of the taxpayers' positions in support of high compensation relate to how well the company has performed as a result of the employee's work. In order to determine whether this position has merit, the company's financial performance must be analyzed.

The financial performance of the taxpayer's business must be compared with the industry as well as with similar businesses (competitors). From this perspective, it can be determined whether or not the taxpayer's business is below average, average, or above average. The result of this analysis then provides support for selecting the compensation of the employee being analyzed at the lower, middle, or upper end of a range.

There are additional reasons why a financial analysis should be done. For example:

- To identify similar companies.
- To explain differences in compensation between competitors based on financial performance.

A detailed explanation of financial analysis is beyond the scope of this Job Aid. Valuation Analysts are trained in this area and should use that training in making the required analysis. It should be pointed out that it is easy to misapply financial analysis. This is particularly true in computing Return on Equity (ROE). See the Income Approach below, as well as the "Hypothetical Independent Investor" discussion in Section IV.

APPENDIX D provides an example of Financial Analysis for a Reasonable Compensation issue.

VALUATION APPROACHES

The three general approaches to valuation can be applied to Reasonable Compensation in the same way that other appraisals are done. The market, income, and cost approaches are applied and reconciled to determine Reasonable Compensation. The success of all three approaches depends on the level of factual development from interviews, IDR responses, and, where necessary, Summonses.

MARKET APPROACH

When first deciding to pursue the issue of Reasonable Compensation, compare the taxpayer's compensation for the subject employee to compensation within the industry. The market approach begins here and focuses as much as possible on the taxpayer's business and the specific position being analyzed (often the CEO who also owns the business). The question to be answered is: How much compensation would be paid for this same position, held by a non-owner in an arms-length employment relationship, at a similar company?

Listed below are some sources of information for applying the market approach.

1. General Industry Surveys by Standard Industry Code (SIC) and North America Industry Classification System (NAICS). See APPENDIX B for examples.
2. Salary surveys within the industry. See trade organization, trade journals, or analysts study.
3. Proxy Statements/Annual Report for publicly traded companies. These are filings required by the Securities Exchange Commission (SEC). It may be difficult to identify similar companies. If a larger company pays less compensation to a comparable employee, this may be an indication that the taxpayer's compensation is not reasonable. Proxy Statements/Annual Reports can be ordered directly from companies or retrieved from Standard & Poor's Research Insight and Compustat, Capital IQ, Lexis/Nexis, or the SEC website.
4. Private company compensation information. Sometimes private companies disclose compensation records to obtain loans, financing, grants, etc. - Dun & Bradstreet or Risk Management Association.

APPENDIX E contains an example of a market approach.

INCOME APPROACH

The income approach can only be correctly applied when the Fair Market Value (FMV) of the company is available for each year that compensation is being examined. The FMV of a business entity often changes from year to year and can be a time consuming challenge to determine for any single year. As a result, the market approach is generally more useful than the income approach in a reasonable compensation analysis.

The income approach is based on an "Independent Investor Test," which seeks to determine whether an independent investor would be satisfied with his/her return on investment when looking at the financial performance of the taxpayer's business in conjunction with the subject employee's level of compensation. See *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1325 n.33 (5th Cir. 1987) where the Court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue and *Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Commissioner*, T.C. Memo. 2011-74 (2011).

The Independent Investor Test creates a rebuttable presumption that an employee's compensation is reasonable if investors obtain a far higher return than they had any reason to expect. The rationale behind the Independent Investor Test is that investors pay employees to work to increase the value of the assets entrusted to their management. A high rate of return indicates that the assets' value increased and that the employee provided valuable services. Thus, if investors obtain returns above what they should reasonably expect, an employee's salary is presumptively reasonable. The presumption is rebutted if the high rate of return is attributable to an extraneous event rather than the manager's efforts. Id.

In applying the Independent Investor Test, the total return to the investor is considered, including dividends, stock appreciation and corporate earnings. See *Home Interiors & Gifts, Inc. v. Commissioner*, 73 T.C. 1142, 1162 (1980). The return is then compared to the equity invested to arrive at the annual return on equity. The compensation deduction may be disallowed in part if the corporation does not meet the Independent Investor Test. *B&D Foundation, Inc.*, TC CCH 54,505(M)(2001).

In many cases there is no business valuation available on which to base the return on investment or equity calculation. It is incorrect to simply use the book equity to compute Return on Equity as a proxy for return on investment. Return on Equity can be meaningful with respect to publicly traded companies because the Equity is marked to FMV every day based on the publicly traded price of the stock. With a private or closely-held company, the book equity rarely represents the FMV of the business entity. For example, a private company might have real estate or other tangible assets with higher FMVs than their book values.

Alternatively, the private company might have unrecorded intangible assets or the owner(s) might have taken excess compensation in the past, all of which would cause the book value to be lower than its fair market value. In such cases, using the book value could artificially inflate the Return on Equity (return on investment).

Assuming that the FMV of the private company can be determined, Return on Equity (return on investment) can then be calculated for any level of compensation and compared against a "Required Rate of Return." This "Required Rate of Return" must be derived for the taxpayer's specific business in the same manner as a discount rate is derived for a discounted cash flow. See the Key Person discussion in Section IV for discussion of the "Required Rate of Return". See also the discussion of The Independent Investor Test under the Income Approach and in Section IV under Taxpayer Arguments. The taxpayer often raises this approach as a defense and applies it incorrectly.

APPENDIX F contains an example of the income approach for determining reasonable compensation.

COST APPROACH

The Cost Approach breaks the duties of the employee into its components such as: company administration, accounting, finance, marketing, advertising, engineering, purchasing, etc. This is usually done via interview or IDR where the total hours worked by the employee are assigned to job functions. Salary surveys are then used to determine the "cost" of each job duty performed by the employee. These are added up to arrive at a total "cost" to replace the duties/ services of the employee.

Taxpayers may claim that the employee performs many jobs and works long hours and therefore is entitled to high compensation. The cost approach breaks the hours spent by the employee down into the various duties performed, quantifies the amount of time devoted to the different responsibilities, and compares the employee's salary to market compensation for comparable positions. A weakness of the cost approach is that an employee might perform many tasks to some degree. It is often difficult to accurately allocate the employee's time to each position and it is also difficult to find market salaries for comparable part-time positions. It is inappropriate to add up market salaries of multiple positions on a full-time basis as this would distort the amount of total time actually worked.

RECONCILIATION

Although standard appraisal practice requires the consideration of all three approaches, the reconciliation in the case of Reasonable Compensation will generally rest heavily on the market approach (comparison to compensation for similar positions in similar companies). The income and cost approaches, as well as financial analysis, are then used to refine the reasonable compensation amount.

SECTION IV: TAXPAYER ARGUMENTS FOR REASONABLE COMPENSATION ISSUES

The taxpayer may rely on one or more of the following five points to support its position as to the appropriate level for current year compensation:

1. Some of the compensation is for prior years' under-compensation.
2. Employee performs multiple jobs.
3. "Hypothetical Independent Investor" test was satisfied.
4. Employee personally guarantees company debt.
5. Employee is a key person at the company or is a superior employee that deserves extraordinary compensation.

Some points to consider in each of these areas are discussed below.

1. PRIOR YEARS UNDER-COMPENSATION

There are three requirements which the courts have suggested are critical to a taxpayer's deduction of compensation for prior years' under-compensation in a current tax year.

The taxpayer must substantiate:

- a. The fact of prior year under-compensation (*American Foundry v. Commissioner*, 59 T.C. 231 (1972), *acq.*, 1974-2 C.B. 1, *aff'd in part and rev'd in part*, 536 F.2d 289 (9th Cir. 1976));
- b. The contemporaneous intent to compensate for under-compensation in a future year (*Perlmutter v. Commissioner*, 44 T.C. 382 (1965), *aff'd*, 373 F.2d 45 (10th Cir. 1967)); and
- c. The specific amount of the under-compensation (*American Foundry*) to be compensated for in a future year and when that compensation will occur.

Taxpayers often argue that a high level of current compensation is to make up for prior years in which the business was not able to properly compensate an employee. When an employee has, in fact, received inadequate compensation in previous years an increase over what otherwise might be the appropriate compensation level for the current year when taken in isolation may be reasonable. In analyzing this argument, it is necessary to consider the substance of past events in line with the substantiation requirements noted above.

Consider:

- Whether the employee was actually underpaid in prior years based upon their performance?
- Did the company generate enough revenue to make reasonable salary payments in prior years?
- Did the employee as a shareholder enjoy an increase in retained earnings or an increase in the value of the company (for example, through stock options) in lieu of receiving compensation on a current basis (for example, as a salary)?
- Was the employee granted deferred compensation in prior years so that the total compensation paid for those years is reasonable?
- What would have been the effect on the corporate tax rate if a reasonable wage had been paid?

An analysis of all of the prevailing facts and circumstances over time is required to make a proper determination. This can be difficult and resource intensive, especially if a Valuation Analyst has inadequate data due to the passage of time. Remember, the burden is on the taxpayer to substantiate deductions. See, for example, *Nicoll v. Commissioner*, 59 TC 37, 50-51 (1972), *acq.* 1973-2 C.B. 3.

See APPENDIX G for a discussion of court cases relating to prior years' under-compensation.

2. MULTIPLE JOBS ("MANY HATS"/MANY HOURS)

Some taxpayers may justify high compensation based on the employees' long hours and the extent of his or her responsibilities. Most high-level employees in a business work longer than a 40 hour work week. *The Officer Compensation Report*, by Panel Publishing, indicates that nearly one third of CEOs work in excess of 60 hours per week during peak times and most work 45 - 60 hours per week even during non-peak times.

The Cost Approach, discussed above under Issue Development, is often a good tool in assessing a taxpayer's position.

The Service's position on this argument has almost always involved one of these points:

- a. Outside interests. See *Estate of Wallace v. Commissioner*, 965 F.2d 1038 (11th Cir. 1992); *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1325 n.33 (5th Cir. 1987) where the Court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered to be reasonable compensation for the years at issue. An employee is entitled to part-time compensation for part-time work.
- b. Non-aggregation of roles: functions vs. services (See *Ken Miller Supply, Inc. v. Commissioner*, T.C. Memo. 1978-228) where the Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue. What is important is the nature and the scope of the services performed not the function implied by the job title.

It is generally expected that a company's top executives will be involved in all aspects of the taxpayer's business and will perform a variety of functions. For example, according to the Occupational Outlook Handbook (United States Department of Labor, Bureau of Labor Statistics, <http://www.bls.gov/oco/ocos012.htm>), Top executives, including chief executive officers, must devise strategies and formulate policies to ensure that, among other things, the following goals and objectives are met:

"In small organizations, such as independent retail stores or small manufacturers, a partner, an owner, or a general manager often is responsible for purchasing, hiring, training, quality control, and day-to-day supervisory duties. In large organizations, top executives not only direct the overall organization, but also may be responsible for implementing strategies and setting the overall direction of a certain area of the company or organization."

The Occupational Outlook Handbook goes on to say that "Top executives are among the highest paid workers; however, long hours, considerable travel, and intense pressure to succeed are

common.” Specifically, “Long hours, including evenings and weekends are standard for most top executives and general managers, although their schedules may be flexible.”

- c. If a Valuation Analyst assigns compensation for each of the employee’s roles, then the Valuation Analyst should determine what fraction of the employee’s time is spent on each respective role. The examiner may then assign estimated part-time compensation corresponding to each role.

See APPENDIX H for a discussion of court cases relating to multiple jobs.

3. PERSONAL GUARANTEE OF DEBT

Taxpayers may take a position that the employee’s personal guarantee for the debt of the corporation is a factor that entitles the employee to a greater compensation level in a current tax year. In certain situations, the courts have found that employee's personal guarantee of the employer's debt is a valid consideration in an overall compensation analysis. See *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987) where the Court agreed with the Service’s position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue and *R.J. Nicoll Co. v. Commissioner*, 59 T.C. 37, 50-51 (1972), *acq.* 1973-2 C.B. 3. To determine the relevant facts, the examiner should review the loan agreements.

Another issue in the personal guarantee of debt by officers or shareholders is whether the substance of the transaction involves debt or equity. Re-classification of debt to equity is a highly factual issue and requires extensive factual development. The Valuation Analyst must develop all relevant facts before making a determination that the guaranteed debt should be re-classified as equity and should coordinate the issue with Counsel as early as possible.

4. INDEPENDENT INVESTOR TEST

The premise behind an Independent Investor Test is that an independent investor will demand a certain level of return on investment (See prior discussion of the Independent Investor Test in Section III). If the return received is at or above that level, the compensation being paid by the entity is presumptively reasonable, subject to rebuttal by the Service based on an analysis of all of the prevailing facts and circumstances.

In *Guy Schoenecker, Inc. v. Commissioner*, T.C. Memo. 1995-539, the Court found that it was not possible to determine what an "independent investor" would require as a return on an investment given the facts in the case and, as a result,

the Court diminished the value of the compensation under the independent investor approach. In that case, the Court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue. (Note: IRS valuation personnel were involved in this case to perform an income approach analysis in support of the rebuttal of the taxpayer's position).

5. KEY PERSON / SUPERIOR EMPLOYEE

A taxpayer may argue that the employee at issue is a key person, without whom the company would either cease to operate or greatly diminish in value. This argument usually arises in the employee-owner situation (i.e., company president who owns a significant portion of the stock in the company). Generally, in these circumstances, an issue may be present in how the taxpayer allocated payments to the employee-owner between compensation for services rendered (a deductible business expense) and compensation that is a return on capital or investment in the business (a dividend for a C corporation; or a distribution for an S corporation for which no deduction is allowable). In making a determination on reasonableness of compensation paid, a Valuation Analyst should compare the owner-employee's compensation with a comparable non-owner employee's compensation.

SECTION V: CONSIDERATION OF PENALTIES

The Valuation Analyst should consider applying accuracy-related penalties in cases where compensation has been determined to be unreasonable. Section 6662 includes penalties for negligence and substantial understatement of tax liabilities. Historically, these penalties have not been recommended because officers' compensation has been listed as an item that is deemed disclosed under the applicable revenue procedures. However, a listed item will only meet the disclosure standard if taxpayers complete the forms and attachments in a clear manner and in accordance with the instructions. In addition, the dollar amounts entered on the forms must be verifiable. The taxpayer must be able to demonstrate the origin of the amount claimed and show that he entered it in good faith on the applicable form.

Revenue Procedure 2012-15 states, "Form 1120, Schedule E, must be completed when required by instructions." Rev. Proc. 2012-15 was issued to update Rev. Proc. 2011-13. The time devoted to business must be expressed as a percentage as opposed to 'part' or 'as needed.'" In *C.T.I. v. Commissioner*, T.C. Memo. 1994-82, *aff'd*, 1732 A.F.T.R.2d (RIA) 1732 (3d Cir. 1995), the court upheld the substantial understatement penalty in a compensation case where the

taxpayer had completed the Schedule E using the words "as needed." In this case, the Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue.

The Revenue Procedure does not apply to "golden parachute payments" or to the extent that remuneration exceeds the \$1 million limit. In *Thomas A. Curtis, Inc. v. Commissioner*, T.C. Memo. 1994-15, the court upheld both the negligence and the substantial understatement penalties finding that the compensation was excessive and unreasonable, resulting in a partial disallowance of the deduction claimed. Here, the Court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue. Reasonable Compensation is generally determined as a range rather than a specific number. If a taxpayer has paid compensation far above or below a reasonable range based on your valuation, research, and consideration of all relevant facts, you should consider applying penalties.

Beginning with tax year 2011, taxpayers must complete Form 1125-E, Compensation of Officers, and attach it to Form 1120 if they deduct expenses for employee compensation and have total receipts over \$500,000. See the Instructions to Form 1125-E for more information.

SECTION VI: SPECIAL CONSIDERATIONS IF THE TAXPAYER IS A TAX-EXEMPT ENTITY

The proceeding sections address Reasonable Compensation issues primarily with a focus on "for-profit" entities. The same concepts generally apply to tax-exempt entities with some special considerations, highlighted in this section. Tax-exempt entities are sometime referred to as "not for-profit" entities or exempt organizations (EOs). These organizations are generally exempt from Federal income taxation under I.R.C. § 501. Exempt organizations file Form 990, Return of Organization Exempt From Income Tax.

Exempt organizations are under the authority of the Exempt Organizations (EO) function of the IRS Tax-Exempt & Government Entities (TE/GE) Operating Division. Thus, in working a Reasonable Compensation issue with an exempt organization, the Valuation Analyst will work with an EO Revenue Agent assigned to the case and may also work with an Employment Tax Specialist and/or an Employee Plans Specialist.

Section 501(c)(3) prohibits inurement and private benefit and, as a result, an exempt organization must pay no more than Reasonable Compensation for services performed by its officers, trustees, and employees. Further, section

4958 imposes on insiders an excise tax on compensation that exceeds fair market value. Economic benefits provided by exempt organizations and treated as compensation are considered with all other components of the recipient's compensation to determine reasonableness for purposes of the section 4958 excise taxes. Economic benefits that are not treated as compensation may still constitute a section 4958 excess benefit transaction. This is a subject for the TE/GE revenue agent assigned to the case.

Taxable *excess benefit transactions* under section 4958(c)(1) are transactions where the economic benefit provided by an *applicable tax-exempt organization* directly or indirectly to or for the use of any *disqualified person* exceeds the value of the consideration given by the disqualified person, *including performance of services by the disqualified person*. Other excess benefit transactions are statutorily specified for certain transactions with donor advised funds and supporting organizations under section 4958(c)(2) and (3).

A disqualified person is, with respect to any transaction, a person who, on the date of the transaction or during the five preceding years, was in a position to *exercise substantial influence* over the affairs of the exempt organization. The law imposes an *excise tax* on excess benefit transactions between these disqualified persons and exempt organizations. The excise tax is 25% of the "excess" and is imposed on the disqualified person, not the exempt organization (sections 501(c)(3) or § 501(c)(4)). A manager (officer, director, trustee, or similarly situated person) is subject to a 10% excise tax if the manager knowingly participates in an excess benefit transaction.

If compensation received by a disqualified person is unreasonable (that is, it exceeds fair market value for the services rendered) then that disqualified person is subject to a 25% excise tax (and an additional 200% tax if the transaction is not corrected) on the excess of the compensation.

Taxes imposed by section 4958 include:

- 25% initial tax (paid by disqualified person) on amount of excess (above reasonable consideration) benefit, or the entire amount that is unsubstantiated as compensation,
- 200% second tier tax (paid by disqualified person), if excess benefit transaction is not corrected (i.e., repaid to applicable tax exempt organization with interest) and
- 10% tax on any organization manager who knowingly participated in the excess benefit transaction. This is capped at \$20,000 per transaction. The manager is not liable if participation is not willful and is due to reasonable cause.

A reasonable compensation analysis for the purposes of section 4958 relies upon the principles of reasonableness in the section 162 context that have already been discussed. The Valuation Analyst should work with the assigned TE/GE examiner to assure that all relevant portions of compensation are considered in the analysis. In addition, the Analyst should consider the appropriate population from which compensation comparables should be drawn – should that population include only tax-exempt entities and their employees or should it include taxable entities and their employees as well? This determination will depend upon the facts and circumstances of the case under analysis.

In working a reasonable compensation issue for an exempt organization you may encounter claims of “initial contract exception” or “rebuttable presumption.” It is important to refer such cases back to the assigned TE/GE agents for their consideration because Reasonable Compensation analysis may not be needed in these cases.

APPENDIX I illustrates Reasonable Compensation analysis using an example in the private college and university sector.