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IRS Guidance Sheds Light on Reasonable Compensation

What constitutes reasonable compensation and how it is treated for federal tax purposes are issues that arise for a wide range of organizations, including closely held C corporations, family businesses and S corporations. An IRS publication provides insight into how taxpayers can expect the agency to review compensation reported on tax returns – and possibly avoid an audit or tax court appearance.

An Unofficial Position

The guidance comes in the form of a "job aid" for IRS valuation analysts. It is intended to assist the analysts in their examination of reasonable compensation and does not represent an official IRS position. (So the job aid cannot be cited as an authority.)

As the guidance notes, IRS analysts usually must determine whether compensation paid is reasonable and, therefore, deductible under Section 162 of the Internal Revenue Code. Section 162 defines reasonable compensation as the amount that would ordinarily be paid for like services by like organizations in like circumstances. It considers both the reasonableness of the total amount paid and the services rendered.

Several Scenarios

According to the IRS, reasonable compensation issues on tax returns typically arise in several contexts:

Closely held C corporations. In these types of companies, where employees are also shareholders, part of their compensation may actually constitute a stock dividend. Dividends are not deductible at the corporate level, but compensation is deductible. Although the income is taxable to the recipient either way, different tax rates could apply depending on the nature of the income (ordinary or dividend)

Family business. Parents may overpay their children for services rendered to the business. In such cases, the business claims a tax deduction for an amount that the IRS considers a gift.

S corporations. To avoid payroll taxes, an S corporation could underpay owners for the work they perform for the business and, instead, pay out hefty distributions. Distributions paid to owners generally are not taxable to the extent that the owner has basis in the company.

Loans. All types of entities may make loans to their employees at no or low interest and with lax terms. Such loans may, in fact, be disguised compensation.

To assess the likelihood of reasonable compensation issues, IRS analysts are instructed to consider several factors, including 1) the entity's process for setting compensation; 2) the number of employees at issue; 3) tax return information (including compensation items that do not appear on an individual's Form W-2); and 4) salary surveys. They are also advised to make sales comparisons (between officers' compensation and company sales) and taxable income comparisons. Typically such comparisons are made by adding the subject compensation back into taxable income to see if the adjustment significantly changes taxable income.

Audit Scrutiny

When auditing compensation deductions, an IRS analyst usually will scrutinize the following:

- Employee qualifications, background, experience and knowledge of the business;
- Nature, extent and scope of the employee's duties (including the character and degree of responsibility the employee assumes);
- Time the employee devotes to the business;
- Size and complexity of the business;
- General and local economic conditions;
- Whether compensation is predetermined based on activities to be performed or not determined until the end of the tax year;
- How much the employee was paid in prior years;
- Salary policy for all employees; and
- Amounts paid by similar-sized businesses in the same sector to equally qualified employees for performing similar services.

Businesses often assert that high compensation is justified by the employee's contribution to the company's success or to make up for years of lower compensation when the business was struggling. In such cases, IRS analysts examine the company's performance to determine whether such an argument might be reasonable

Inside Knowledge

Plenty of tax court precedent is available on reasonable compensation matters. However, your clients would probably prefer to avoid court altogether. Recent IRS guidance can help preempt disputes with the agency over how employees are compensated and how it is treated for federal tax purposes.

Applying 3 Common Valuation Methods

The IRS job aid on reasonable compensation suggests that the following three business valuation approaches also apply when estimating reasonable compensation:

1. **Market.** This approach compares the subject compensation to compensation within the industry. IRS analysts are advised to begin with this approach when deciding whether to audit reasonable compensation
2. **Income.** This method determines whether an independent investor would be satisfied with the business's financial performance at the current owners' compensation levels.
3. **Cost.** Here, a valuator breaks the employee's duties into its components, uses salary surveys to determine market compensation for each component and calculates a total cost.

The guidance notes that standard appraisal requires consideration of all three approaches, but the IRS guidance generally favors the market approach. The income and cost approaches, as well as financial analysis, serve to refine the reasonable compensation estimate.