Best Practices

Reasonable Compensation Analysis for C Corporations and S Corporations

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The reasonableness of shareholder/employee compensation is often a highly controversial issue in the context of federal income taxation. This is because what is considered reasonable compensation by the shareholder/employee taxpayer is often considered unreasonable by the Internal Revenue Service ("Service"). According to Internal Revenue Code Section 162, in order to be deductible for federal income tax purposes, executive compensation must be (1) "reasonable in amount" and (2) "based on services actually rendered." The income tax–related consequences associated with unreasonable shareholder/employee compensation can be significant (and include payroll taxes, late payments, and tax return filing penalties). For this reason, it is important that valuation analysts and other financial advisers understand the factors that the Service and the federal courts consider when analyzing the reasonableness of shareholder/employee compensation. This discussion focuses on the generally accepted factors and methods used to analyze the reasonableness of shareholder/employee compensation.

Introduction

The reasonableness of shareholder/employee compensation is an important, and often controversial, income tax consideration for closely held corporations. This is particularly true for the closely held corporation structured as either a C corporation or an S corporation.

This is because the shareholder/employees of such closely held corporations are often motivated to deviate from arm's-length levels of compensation in order to minimize their income tax burden.

For this reason, the reasonableness of compensation paid to the shareholder/employees of such closely held corporations is often one of the first issues scrutinized by the Service during the examination of either the employee or the employer corporation.

And, the income tax-related consequences associated with a finding of unreasonable shareholder/employee compensation can be significant. These consequences can include payroll taxes plus late payments, and return filing penalties.

For the S corporation shareholder/employee, the Service is typically concerned with an unreasonably low level of employee compensation. This is because "S corporation earnings are not subject to the self-employment tax, so officer/shareholders often receive minimal, small, or no wages salary income to avoided employment taxes."[1]

That is, earnings distributed to S corporation shareholder/employees in excess of payments for services rendered to, or on behalf of, their companies are not subject to various federal employment taxes. Such employment taxes include FICA, FUTA, Medicare, and others.

For a C corporation, the Service is typically concerned with an unreasonably high (or excessive) level of employee compensation. In such cases, the Service often claims that the excess employee compensation:

1. absorbs taxable income and
2. represents a disguised dividend to the shareholder/employee.

The Role of the Valuation Analyst

Valuation analysts and other financial advisers often analyze the reasonableness of closely held corporation shareholder/employee compensation for various reasons. These reasons include income taxation, financial accounting, ownership transition, litigation, and corporate governance reasons.

To ensure that reasonable compensation analyses can withstand the scrutiny of the Service or the federal courts, it is important that the valuation analyst fully understand what factors and methods should be considered when determining the reasonableness of shareholder/employee compensation.

This discussion focuses on the generally accepted factors and methods that should be considered during an analysis of the reasonableness of shareholder/employee compensation for a C corporation or an S corporation.

The Reasonable Compensation Objective

This discussion does not focus on the reasonableness of compensation paid to the owners of partnerships, sole proprietors, or limited liability companies (LLCs). This is because the compensation paid to owners of these types of entities are characterized as distributions—which are not subject to employment taxes.

For the purposes of this discussion, the objective of a reasonableness of compensation analysis is to estimate the amount of shareholder/employee compensation that is reasonable and thus deductible as a business expense under Internal Revenue Code Section 162 ("Section 162").

To achieve this objective, valuation analysts often look for guidance both to:

1. Securities and Exchange Commission (SEC) administrative rulings and
2. judicial precedent.

The following discussion considers some of the SEC administrative rulings and the judicial precedent that valuation analysts and other financial advisers may look to for procedural guidance when analyzing the reasonableness of shareholder/employee compensation.

Reasonableness of Shareholder/Employee Compensation

For income tax purposes, the reasonableness of shareholder/employee compensation is often controversial. This is because, like other business expenses, salaries, wages, and other executive compensation should be directly connected with a trade or business in order to qualify for a tax deduction.

According to Regulation Section 1.162-1, "Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. . . . Among the items included in business expenses are management expenses."

According to Section 162(a)(1), "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered."

The difficulty in estimating reasonable compensation is that the amount that is considered reasonable to one party is often considered unreasonable to another party.

Mad Auto Wrecking, Inc.

The struggle to determine what is a reasonable amount of compensation was articulated in *Mad Auto Wrecking, Inc. v. Commissioner*, as follows:

> Inherently there is a natural tension between: (1) shareholders/employees who feel that they are entitled to be paid from a corporation's profits, even to the exhaustion thereof, of an amount that reflects their skills and efforts, and (2) a provision in the tax law that conditions the deductibility of compensation on the concept of reasonableness. What is reasonable to the entrepreneur/employee often may not be to the tax collector. The term "reasonable", however, must reflect the intrinsic value of employees in the broadest and most comprehensive sense.[2]

The form of employee compensation does not affect its tax deductibility to the taxpayer corporation.[3] What is important, however, is that the employee compensation should reflect what would "ordinarily be paid for like services by like enterprise under like circumstances."[4]

Therefore, in order to qualify as an income tax deduction, employee compensation should meet four requirements.

Tax Deduction Requirements

These four requirements for an employee compensation income tax deduction, as described in Regulation Section 1.162-7, are:

1. an ordinary and necessary expense,
2. reasonable in amount,
3. based on services actually rendered, and
4. actually paid or incurred by the taxpayer corporation.

In short, the provisions in the regulations are intended to prevent the employer corporation from characterizing amounts that are actually dividends as salary (i.e. employee compensation).

In addition, the determination of what is a reasonable amount of shareholder/employee compensation is made based on the specific facts and circumstances of each individual case.[5]

And, according to Regulation Section 1.162-7, this determination is made based on consideration of the subject taxpayer facts that exist at the "date when the contract for services was made, not those existing at the date when the contract is questioned" by the Service.

Income Tax Considerations

For the S corporation, the Service is typically concerned with whether the shareholder/employee is paid an unreasonably low level of compensation.

This is because the S corporation "noncompensation" income distributions are not subject to compensation-related employment taxes, such as Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), State Unemployment Tax Act (SUTA), Medicare insurance, and others.

Accordingly, the lower the amount of the shareholder/employee compensation, the lower the amount of employment taxes paid by both (1) the employee and (2) the employer corporation.

For this reason, an S corporation shareholder/employee may often "pay" himself by taking periodic S corporation income distributions instead of taking a reasonable salary.

In such cases, both the S corporation employer and the shareholder/employee avoid paying employment taxes when the shareholder takes noncompensation income distributions. This is because noncompensation S corporation income distributions do not qualify as wages, so they are not subject to employment taxes.

When an S corporation allocates an unreasonably small percent of its corporate earnings as compensation, the Service may challenge the reasonableness of the shareholder/employee compensation.

For the closely held C corporation, the Service is typically concerned with whether the shareholder/employee is paid an excessive amount of compensation. This is because compensation payments are a tax-deductible expense for the C corporation.

Accordingly, the greater the amount of shareholder/employee compensation, the lower the amount of the C corporation taxable income.

Unreasonable, or excessive, amounts of shareholder/employee compensation, however, may be recharacterized by the Service as nondeductible dividend payments. That is, no income tax deduction is allowed to a C corporation for compensation paid to the shareholder/employee that exceeds a reasonable amount.

Factors Specific to an S Corporation

There are several factors specific to an S corporation that should be considered in the analysis of the reasonableness of shareholder/employee compensation.

As with a C corporation, according to Regulation Section 1.162-7(a), the S corporation shareholder/employee compensation should be (1) reasonable in amount and (2) purely for services rendered.

Moreover, under Regulation Section 31.3121(d)-1(b), the S corporation officers are considered to be employees of the taxpayer corporation when they provide more than minor (i.e., substantial) services to that corporation.

In addition, according to Revenue Ruling 59-221, the S corporation shareholder income distributions are exempt from self-employment tax.

Furthermore, according to Revenue Ruling 74-44, the dividends paid to S corporation shareholders will be recharacterized as wages when such dividends are paid to shareholders in lieu of reasonable compensation for services performed for the S corporation.

Based on the above-listed regulatory guidance, the Tax Court and other federal courts typically look at several factors when determining if a payment made by an S corporation to a shareholder/employee is either a dividend or employee compensation.

Dividends or Compensation?

Typically, the federal courts have found that S corporation dividends made to shareholders are actually disguised employee compensation subject to employment taxes when the following factors are present:[6]

1. The S corporation employee/shareholder performs substantial services to the taxpayer corporation but receives little or no employee compensation.
2. The S corporation employee/shareholder receives profit distributions in proportion to the amount of stock owned in the taxpayer corporation.
3. No other individuals work at the S corporation business.
4. The S corporation employee/shareholder owns most or all of the company stock.
5. Corporate distributions are characterized as shareholder loans, but there are no supporting shareholder loan documents.
6. The S corporation employee/shareholder worked elsewhere at a similar position but earned a much higher wage in that position.
7. The S corporation does not have a specific fixed formula for determining the amount of the employee/shareholder salary.
8. The S corporation employee/shareholder compensation rate is less than the compensation rate for a comparable position at a comparable company.
9. The S corporation employee/shareholder is compensated at a rate lower than other nonshareholders/employees who work in similar positions at the subject company.

If challenged by the Service, the taxpayer corporation bears the burden of proof to demonstrate that the amount of the shareholder/employee compensation is reasonable.[7]

Moreover, if some amount of the shareholder/employee compensation is determined to be excessive, then only that portion of the compensation that is determined to be reasonable will be deductible.[8]

Given the controversial aspects associated with the reasonableness of shareholder/employee compensation, it is important that the valuation analyst understand the factors and methods that the Service and the federal courts typically consider when testing the reasonableness of shareholder/employee compensation.

Methods Used to Estimate Reasonable Compensation

Several methods are available for conducting a reasonableness of shareholder/employee compensation analysis. These methods can be grouped into two broad categories or classifications. While the specific titles of these two generally accepted methods may vary, the generic names of these methods are as follows:

1. The multifactor test
2. The independent investor test

These generally accepted methods were developed over many years based on statutory authority, administrative rulings, and judicial precedent.[9]

The valuation analysts, the Service, and the federal courts will typically rely on one, both, or a combination of these two generally accepted methods to analyze the reasonableness of shareholder employee compensation.

The Multifactor Test

For many years, the Service and the federal courts have used a multifactor analysis to test the reasonableness of shareholder/employee compensation. A multifactor analysis is an analytical method used to solve a complex problem based on an analysis of the relevant factors that contribute to the complexity of the problem.

The generally accepted reasonableness of employee compensation factors used by many courts today were first articulated over 60 year ago in the *Mayson Manufacturing Company v. Commission* decision.[10]

More recently, in *Pulsar Components International, Inc. v. Commissioner*,[11] the Tax Court expanded the *Mayson* factors to include the following factors that should be considered with respect to the reasonableness of compensation:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's work
3. The size and complexities of the employer's business
4. A comparison of salaries paid with the employer's gross and net income
5. The prevailing general economic conditions
6. A comparison of salaries with distributions to officers and retained earnings
7. The prevailing rates of compensation for comparable positions in comparable concerns
8. The salary policy of the employer as to all employees
9. the amount of compensation paid to the particular employee in previous years
10. The employer's financial condition
11. Whether the employer and employee dealt at arm's-length
12. Whether the employee guaranteed the employer's debt
13. Whether the employer offered a pension plan or profit-sharing plan to its employees
14. Whether the employee was reimbursed by the employer for business expenses that the employee paid personally

Importantly, the reasonableness of shareholder/employee compensation factors presented in the *Pulsar* case include the factors specified by the Service in its audit manual.[12]

The valuation analyst typical considers the above-listed factors as part of an analysis of the reasonableness of shareholder/employee compensation.

One relevant factor in the analysis of reasonable compensation is the prevailing rates of compensation for comparable positions in comparable companies. Several methods used to analyze this reasonableness of compensation factor typically including the following:

1. Financial ratio analysis
2. Industry salary survey analysis

These methods are used to estimate a range of reasonable compensation for a subject shareholder/employee. The range is based on an analysis of the compensation paid at "guideline" companies (or industries) to executive with similar duties, responsibilities, skills, and functions.

Financial Ratio Analysis

In a financial ratio analysis, the compensation of the subject shareholder/employee is compared to the subject company sales, profit before interest and taxes, assets, and other financial measures. These subject company financial ratios are then compared to comparable company and/or industry ratios.

Many sources of executive compensation empirical data are available to develop comparable company financial ratios.

The primary sources of executive compensation empirical data include the following:

1. Benchmark surveys—typically compiled by an association or consulting firm with ties to an industry
2. Subscription databases—typically a pay-per-project or annual subscription proprietary database compiled from industry data and SEC fillings
3. Internet sites—typically these are free sites with less robust data and limited features
4. Printed texts—typically most relevant for small, unique companies
5. Public company proxy statements

Each of these data sources can be used to develop comparable company and/or industry financial ratios. This topic is discussed in further detail in the next article in this *Insights* issue.

For example, in a proxy statement analysis, the reasonableness of executive compensation is estimated based on a comparison of the subject shareholder/employee compensation to the levels of compensation paid to comparable executives of comparable public companies.

In December 2006, the SEC adopted new rules related to the disclosure of public company executive and director compensation.

These SEC rules require publicly traded companies to disclose in their proxy statements the total compensation of the company's five most highly paid executive officers.

These SEC proxy statement disclosures of total executive compensation can be used to develop a market-based range of compensation (e.g., expressed as a ratio of revenue and/or earnings) for:

1. comparable publicly traded companies or
2. a particular industry.

As with any market-based ratio analysis, the valuation analyst should have a thorough understanding of the subject company and the subject industry before using this method.

This is because macroeconomic trends and industry fluctuations can result in significant variability in market-based financial ratios.

In addition, the reliability of a financial ratio analysis can be affected by:

1. the comparability of the subject company to the selected publicly traded companies or industry and
2. the quantity and quality of information disclosed in the selected data source.

Properly applied, however, financial ratio analysis can provide the valuation analyst with relevant market-based information with which to assess the reasonableness of shareholder/employee compensation.

Industry Salary Survey Analysis

In an industry salary survey analysis, the valuation analyst analyzes the levels of actual compensation paid to comparable executives within the subject industry.

As previously described, an important factor to consider in determining the reasonableness of shareholder/executive compensation is the prevailing rates of compensation paid for comparable executive positions in comparable companies.

Typically, to be considered "comparable," companies generally operate in the same industry (or line of business) with similar clients, products, and suppliers, and are of similar size, usually measured in terms of assets or sales.

The subject shareholder/employee position may be considered comparable to an industry survey executive position if the nature and scope of the duties performed in both positions are similar.

In many closely held corporations, however, the duties and responsibilities of the subject shareholder/employee may not easily be characterized into one position. For example, the subject shareholder/employee duties and responsibilities may encompass the positions of CEO, top salesman, and head of human resources.

To ensure the subject shareholder/employee position is comparable to the industry survey executive position, the analyst should develop an understanding of the actual duties and responsibilities of the individual shareholder/employee.

In addition, to properly use the industry salary survey data it is important to understand:

1. how the data are compiled,
2. the timeliness of the data, and
3. the data comparability to the subject company and/or position.

The Independent Investor Test

Another generally accepted method used to analyze the reasonableness of shareholder/employee compensation is the independent investor test.

The independent investor test is based on an analysis of the actual rate of return on owners' equity of the subject company compared with a market-derived required rate of return on owners' equity.

This independent investor test analysis may be performed at various assumed levels of shareholder/employee compensation.

The independent investor test is often considered by the U.S. Tax Court (and by other federal courts) to be a meaningful method of indirectly testing the reasonableness of shareholder/employee compensation.

In *Elliotts, Inc. v. Commissioner*,[13] the Tax Court noted that the independent investor test considers whether an outside investor in the taxpayer corporation would have approved the subject executive compensation.

An example of the application of the independent investor test is presented in *Exacto Spring Corporation v. Commissioner*. The judicial decision in the *Exacto Spring Corporation* case is summarized as follows:

> A corporation can be conceptualized as a contract in which the owner of assets hires a person to manage them. The owner pays the manager a salary and in exchange the manager works to increase the value of the assets that have been entrusted to his management; that increase can be expressed as a rate of return to the owner's investment. The higher the rate of return (adjusted for risk) that a manager can generate, the greater the salary he can command. If the rate of return is extremely high, it will be difficult to prove that the manager is being overpaid, for it will be implausible that if he quit if his salary was cut, and he was replaced by a lower-paid manager, the owner would be better off; it would be killing the goose that lays the golden egg.[14]

Independent Investor Test Summary

In other words, the maximum salary that an independent investor would be willing to pay a corporate officer is a function of:

1. the expected return an investor would demand for his investment in the corporation, and
2. the actual return on investment after all expenses, including officer compensation, have been paid.

Independent Investor Test Example

The independent investor test can be demonstrated in the following simplified illustrative example.

Let's assume that a company has a net worth of $10 million. If an independent equity investor in the company requires a 10 percent return on equity, then the company would need to generate net income of $1 million to satisfy the investor.

If paying the company manager a particular salary causes net income to fall below the investor's expected rate of return, then it is unlikely that the independent investor would agree to pay that salary.

Further Reading

Parker, James, and Claire &. Nash. "Compensation Planning Concerns Differ for C and S Corporations." *Business Entities* (September/October 2008): 34–49.

Summary and Conclusion

Shareholder/employee reasonable compensation is an important, and often controversial, income tax consideration.

This is because what is considered a reasonable level of compensation by the individual or corporate taxpayer is often considered unreasonable by the Service. This is particularly true for the shareholder/employee of a C corporation or an S corporation.

This is because the shareholder/employee of such a closely held corporation is often motivated to deviate from an arm's-length levels of compensation in order to minimize his or her income taxes.

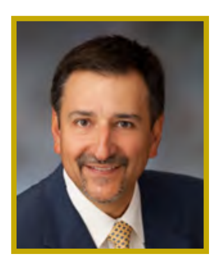
Over the years, the Service and the federal courts have developed generally accepted factors and methods used to analyze the shareholder/employee reasonableness of compensation. These generally accepted methods were developed based on statutory authority, administrative rulings, and judicial precedent.

To ensure that reasonable compensation analyses can withstand the scrutiny of the Service and the federal courts, the analyst (and the taxpayer) should fully understand the generally accepted factors and methods that are considered when determining the shareholder/employee reasonableness of compensation.

This discussion focused on the generally accepted factors and methods that should be considered during an analysis of the shareholder/employee reasonableness of compensation for both a C corporation and an S corporation.

Notes:

1. *Internal Revenue Manual* Section 4.35.2.5.2.2 (05-05-2006) Officer's Salaries.
2. Mad Auto Wrecking, Inc. v. Commissioner, T.C. Memo 1995-153.
3. Treasury Regulation 1.162-7(b)(2).
4. Treasury Regulation 1.162-7(b)(3).
5. Internal Revenue Code Section 162(a)(1).
6. Reilly, Robert F. "Reasonableness of Shareholder/Employee Compensation in Closely Held Business Valuation," *American Journal of Family Law* (Fall 2005).
7. Long Island Drug Co., Inc. v. Commissioner, 111 F.2d 593 (2d Cir. 1940).
8. Treasury Regulation 1.162-8.
9. See for example: Pulsar Components International, Inc. v. Commissioner, T. C. Memo 1996-129; Elliotts, Inc. v. Commissioner, 48 TCM 1245, T.C. Memo 1984-516; Mad Auto Wrecking, Inc. v. Commissioner, T.C. Memo 1995-153; Exacto Spring Corporation v. Commissioner, 196 F.3d 833, 838 (7th Cir. 1999).
10. Mayson Manufacturing Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949).
11. Pulsar Components International, Inc. v. Commissioner, T. C. Memo 1996-129.
12. *Internal Revenue Manual* Section 4.35.2.5.2.2 (05-05-2006) Officer's Salaries.
13. Elliotts, Inc. v. Commissioner, 48 TCM 1245, T.C. Memo 1984-516.
14. Exacto Spring Corporation v. Commissioner, 196 F.3d 833, 838 (7th Cir. 1999).



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