Addressing Reasonable Compensation

By Stephen D. Kirkland, CPA, CMC, CFC

Executives tend to be well paid in corporate America. In response, the media is debating whether these executives are really worth the amounts they are taking home. And, since the answer to that question has dramatic tax consequences, the Internal Revenue Service is paying close attention to this debate.

The income tax laws allow corporations to deduct “ordinary and necessary” expenses incurred in carrying on their businesses. This includes compensation for services performed by stockholders and their family members, but only if the amounts paid are “reasonable” for the services performed.

C Corporations

A closely-held C corporation paying excessive compensation to a shareholder-employee is required to treat the excess portion as a dividend (provided there are adequate earnings and profits) rather than as compensation. This has unfavorable tax consequences for the company, since a dividend is not deductible. Therefore, funds withdrawn from a C corporation as dividends are effectively taxed twice – to the corporation and the shareholder-employee. Compensation is taxed only once – to the employee.

Whether compensation is reasonable depends on all the facts and circumstances. The analysis can be complex and requires judgment. But compensation may be considered to be reasonable if the same amount was paid for comparable services provided by someone other than a stockholder. A true comparable, however, is rarely available.

Be sure to consider how much an employee would be paid if the business was owned by an unrelated investor. After payment of all compensation, are there enough earnings left in the company to satisfy this hypothetical investor? If so, that may be one factor which suggests that the compensation was reasonable.

To determine a reasonable level of pay for an employee, we must consider many additional factors. For example, look at the employee’s input – long hours, special skills, relationships, years of experience and education brought to the job.
We must also look at the employee’s output, or the results he or she achieved. After all, pay for key employees should be performance-based. Consider new clients and contracts brought to the company, increases in profitability, and similar accomplishments. Measuring one person’s accomplishments can be difficult and time-consuming, however, since most accomplishments come from the efforts of several people working together.

Also consider the size of the company, the complexity of the industry, economic conditions, the geographic location and other factors.

An executive’s compensation for a particular year may include an amount for services he or she performed in an earlier year. Business owners often receive reduced pay in the early years of a business, even though that may be when they work the hardest. They also may not be adequately paid during periods of rapid growth, when cash flow is tight. If so, they may be entitled to catch-up pay later. If an employee will be underpaid until a new business becomes profitable, and will receive proportionately larger pay later, consider stating that in board minutes or an employment agreement.

In addition to an employee's salary, employer-provided benefits should be considered in determining whether an employee's compensation is reasonable. This includes pension and welfare benefits, as well as fringe benefits such as personal use of a company car. An otherwise high salary might be reasonable if the employee’s benefits are less than those usually provided to a comparable employee.

Due to the potentially adverse tax consequences, you should advise shareholder-employees to carefully document the reasonableness of their compensation and explain how the amount was determined. Documentation should describe the unique and valuable nature of the individual’s skills and of the services provided.

If a year-end bonus is to be awarded, the terms should be written out in advance. The bonus may be equal to some percentage of the increase in pretax profits over the prior year, for example. If awarded, a resolution should explain how and when the bonus was earned and computed.

**S Corporations**

S corporations, on the other hand, are inclined to keep the compensation of shareholder-employees low. This is because their compensation is subject to payroll taxes, but distributions to stockholders are not. (Either way, S corporation earnings are subject to income tax only once.)

Federal and state tax authorities are aggressively reviewing S corporations to ensure they pay enough payroll taxes on funds turned over to stockholders. As with C corporations, records should be kept to support how compensation levels were determined.
Charities

The Internal Revenue Service also keeps a close eye on tax-exempt organizations to ensure that their exempt status is not abused. Under Internal Revenue Code section 4958, the IRS can impose a 25% excise tax on the unreasonable portion of compensation received by a key employee. The IRS can also impose a 10% excise tax on officers or directors who permitted the excessive payment. These excise taxes are imposed upon the individuals, not on the charity.

The Code refers to this unreasonable compensation as an “excess benefit transaction” because the executive is getting a benefit (compensation) in excess of the value of services he or she provides in exchange.

FIN 48

In July 2006, the Financial Accounting Standards Board issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (“FIN 48”). Under FIN 48, preparers of financial statements must recognize and measure uncertain tax positions taken by the company. Among other things, disclosure of the potential impact of these positions is required. This includes estimating and disclosing the amount of the company’s *potential* tax assessments. One of the issues comprehended by FIN 48 is a potential tax assessment due to payment of unreasonable compensation.

Who else is asking?

IRS agents are not the only ones concerned with compensation amounts that may be excessive. Many parties have a vested interest in this issue. Directors, shareholders, creditors, bankruptcy trustees, and others are looking closely at the compensation packages executives craft for themselves. And they all have their own opinions as to what an employee’s services are worth. But not everyone understands the complex factors which come into play. So, the reasonableness of executive compensation packages may continue to be one of the most debated issues in the business world for years to come.

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