VH Valuations

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It's only reasonable: 5 Factors to Help Determine Reasonable Compensation

The question of reasonable compensation is frequently debated in shareholder disputes, divorces and IRS audits. Owners' compensation is a discretionary expense that controlling owners can alter. It can vary significantly from company to company depending on many factors, including the owner's education, licenses, training and salary history; the business's size and financial health; the business's location; industry trends; and the state of the economy. A valuator can help a company estimate a range of reasonable compensation that eliminates "owner bias" and adjusts income to a level that reflects economic reality based on objective market data.

The IRS and the Tax Court weigh in

It's not unusual for the IRS to question the compensation that closely held companies pay their owners. But in a 1983 decision, *Elliots Inc. v. Commissioner*, and in several subsequent decisions, including *Multi-Pak Corp. v. Commissioner*, the Tax Court provided some guidance, articulating five factors, or tests, that often come into play in determining whether an owner-employee's compensation is reasonable:

1. ***Employee's role.*** This focuses on the employee's importance to the success of the business, including his or her position, hours worked and duties performed. For instance, in the *Multi-Pak* case, the court found that, during a two-year period, the owner "made every important decision" for Multi-Pak's operations, and that his efforts "directly contributed" to its financial condition.

2. ***Comparison with other companies.*** How does compensation compare with that paid by similar companies for similar services? This factor frequently calls for expert testimony, because valuators have the expertise to evaluate appropriate comparable businesses.

3. ***Company's character and condition.*** This factor considers the company's size as measured by its sales, net income or capital value; the complexities of the business; and general economic conditions.

4. ***Potential conflicts of interest.*** When an employee controls a company, his or her relationship with it is closely scrutinized. For example, does the relationship allow the company to disguise nondeductible corporate distributions as compensation? However, in subchapter S corporations, owner-operators may do the opposite — attempt to disguise owner compensation as distributions. When compensation is understated in this way to avoid payroll taxes, the IRS may challenge the amount. The Tax Court may apply the "independent investor test." According to the test, if the company's earnings on equity after payment of the

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owner's compensation would satisfy a hypothetical independent investor, the compensation would probably be reasonable.

5. ***Internal consistency*.** An internal inconsistency in the company's compensation policies may indicate that the payments are unreasonable compensation.

What's reasonable?

Of course, reasonable replacement compensation may, on occasion, differ from the criteria the Tax Court uses to challenge executive compensation. In the business world, for instance, it may be possible to justify paying much more than what might be considered reasonable to maintain the operation if the company requires special talents to improve or dramatically grow. There are always exceptions, and reasonableness is, to some extent, in the eye of the beholder. But typically, reasonable compensation is objective, unbiased and based on relevant empirical data.

But the Tax Court's decisions and analysis provide a valuable roadmap for withstanding IRS challenges. Business owners, attorneys and other interested parties can benefit from understanding the five factors the Tax Court takes into account when evaluating reasonableness of an owner's compensation. Qualified experts apply these factors — and others — to help enable business owners and attorneys to prevail in court. © *2013*