

How the IRS Determines Reasonable Compensation and What You Should Do

An E-Book to accompany Part Four
of my book [Business Valuations and the IRS:](#)

[Five Books in One,](#)

by Michael A. Gregory

Background

During my career at the IRS I was actively involved with reasonable compensation issues over a six-year period of service in the Tax Exempt and Governmental Entities (TEGE) Division. I also handled reasonable compensation issues related to for-profit entities with the Large Business and International (LB&I) and Small Business and Self-Employed (SBSE) divisions. For TEGE I was involved in many projects related to reasonable compensation, including a credit counseling compliance project; separate initiatives on reasonable compensation, and reasonable compensation as applied to hospitals and physician practices, colleges and universities, and unrelated business activities. I also led an effort on reasonable compensation as it relates to S-corporations. Much of my perspective on the reasonable compensation issue thus derives from my background within the IRS and from feedback received from others while working on this issue outside of the IRS. Since leaving the IRS in 2011, I have taught the issue of reasonable compensation as subject matter and also have consulted with clients on how to approach this issue. I have also reviewed and commented on reports related to reasonable compensation.

Working with the IRS to Resolve Issues Related to Reasonable Compensation

Having worked for the IRS for 28 years, with the IRS in the private sector for over 6 years and having worked with neuroscientists on conflict resolution issues over the last four years, I want to share some information at a high level with you related to the IRS and resolving issues. This involves four stages:

1. Develop a Relationship

Our typical reaction to being questioned or challenged is to respond negatively. This is natural. However, in anticipation of this reaction it is very important to de-escalate this emotion, remain calm, remain professional, work on communication to have a conversation by listening, moving towards a discussion that may lead to open dialogue related to understanding interests related to your negotiation on valuation. However, as motivated as you may be to move directly into negotiations, neuroscience suggests developing a relationship first.

To develop a relationship will take some research. Ask who you will be meeting with. Learn as much as you can about the participants from social media and from other contacts. Come to the first call or first meeting asking if the other party would be willing to spend a few minutes so we could get to know each other a little bit so as to develop an element of trust. In my books [The Servant Manager](#), [Peaceful Resolutions](#) and [Business Valuations and the IRS](#), I offer detailed ideas with real-world examples on how to approach this process.

2. Listen to Understand

Listening to understand means asking open ended questions, paraphrasing what the other party stated, summarizing and not offering your opinion or solutions.

By listening to the other party, you can work to uncover interests or concerns and you may very well discover elements that the other party has misunderstood or may not be aware of as part of the process. Since 2010 the IRS has cut its training budget by over 90%. IRS employees are not receiving the education and training that they need. Be open minded and listen to where they are coming from. Listen to understand so that later you may be able to help educate the participants at the IRS.

3. Educate to Inform

Many appraisers have been told not to be an advocate for their client, but for their work. In this instance, I believe being an advocate for your work is misguided. Rather, you need to be there to educate the IRS on what you did and why very similar as to how you would educate a judge on a case. You don't educate the judge as if it were a debate. You educate a judge by presenting information in such a way as to demonstrate your professionalism, your integrity, your ability to explain complex elements in simple terms and by gaining the trust of the judge. Keep this in mind relative to your interactions with the IRS. You are there to educate the IRS at this stage.

4. Focus on Interests

You are now ready to begin the process of a negotiation. I offer a [weekly blog commentary](#) related to this topic with the IRS and others. Valuation is an inexact science. It is actually an art as well as a science. You need to be able to tell a story that makes sense to a third party. You need to negotiate with the IRS by understanding their interests. You need to understand who the decision maker is. The decision maker is not the IRS business valuer. The initial decision maker is the agent or the estate and gift tax attorney. The ultimate decision maker is the manager of the agent

or the manager of the estate and gift tax attorney.

Keep that in mind relative to your discussion of interests on who you are trying to impact related to your valuation issue. This may take several iterations to ultimately have your client reach the right parties as the decision maker on the issue. The key is to uncover interests. You as the valuer may not be in the final meetings, but your client may very well be meeting with the decision maker after both sides have brought their valuers to the initial meeting(s).

If you are involved with the IRS on a business valuation issue you can always contact Mike Gregory at 651-633-531 and at mg@mikegreg.com. He would more than happy to assist you with your concerns.

Reasonable Compensation Job Aid

Here is a [link to three IRS Job Aids](#). From this link note that of the two links from the Job Aid link relate to the [IRS Job Aid on Reasonable Compensation](#) and the associated [Appendices](#). I am suggesting you download these as a reference.

Note that IRS Job Aid on Reasonable Compensation was written for IRS business valuers and the caveat on the front cover states, "This Job Aid is not Official IRS position and was prepared for reference purposes only; it may not be use or cited as authority for setting any legal position." However, there is nothing that prevents you as a business valuer from using this guidance as you work on this issue. After all this is the guidance being presented to IRS business valuers.

[Code Section 162](#) defines deductible expenses and the corresponding [Regulation Section 1.162-7](#) addresses

the definition of reasonable compensation. Reasonable compensation is based on the concept of [Fair Market Value](#).

The IRS Job Aid makes recommendations regarding using various text sources in the preparation of the Reasonable Compensation Job Aid. These are:

[*Financial Valuation: Applications and Models*, James Hitchner, John Wiley & Co. \(2006\)](#)

Reasonable Compensation: Do You Know Where Your Circuit Stands?, Melanie McCoskey, 109 Journal of Taxation, (October 2008)

[*Valuing a Business*, Shannon Pratt, Irwin Press, 5th Edition \(2010\)](#)

[*Reasonable Compensation: Application and Analysis for Appraisal, Tax and Management Purposes*, Ron Seigneur & Kevin Yeanoplos, Business Valuation Resources, LLC, Portland, OR \(2010\)](#)

Reasonable Compensation, BNA portfolio 390, 5th Ed., Tax Management (2011)

Note that the IRS advises cautions with respect to this issue as follows:

This is a Sensitive Issue

Focusing on "Reasonable Compensation"

Be Careful to Protect Information

The Amount is Interpretive

Comparisons with the Right Parties is Often Key

A Thorough Interview is Important – See Appendix C Information Documents Requests on what types of questions to ask.

KEY FACTORS IN REASONABLE COMPENSATION

In the text of [Business Valuations and the IRS: Five Books in One](#) there are 23 key factors identified for consideration with respect to reasonable compensation and nine different sources of possible data.

All data sources should be clearly researched so that you as a business valuer understand the implications and limitations related to the sources and accuracy of the information you use in any valuation

Some comments are made regarding various sources in the Job Aid.

For Smaller Companies consider:

[RMA Annual Statement Studies](#); and

[Troy's Almanac of Business and Industrial Financial Ratios](#);

For All Companies consider:

[Reasonable Compensation: Application and Analysis for Appraisal, Tax and Management Purposes offered by BVR](#);

Trade Groups and Industry Sources

[Industry Norms and Key Business Ratios Published by Dunn & Bradstreet Credit Services annually](#); and

The Job Aid offers a caution regarding [Economic Research Institute, ERI](#);

“It is suggested that [ERI data be used with caution](#) and mainly for risk analysis and planning purposes, that is, use it to determine whether or not a reasonable compensation issue might exist”

Sources of information may include:

[Research Librarians](#) for specific industries. Explore these locally.

For larger corporations and executive compensation consider:

[Watson Wyatt Annual Salary Surveys](#);

[Survey Report on Top Management Compensation](#);

[Top Executive Compensation Published by the National Industrial Conference Board annually](#); and

[Executive Compensation and Taxation Coordinator Published by Research Institute of America \(RIA\) annually](#)

Other sources consider:

Proxy Statements and Annual Reports from the SEC;

From the Company;

[S&P Research Insight](#);

[Compustat](#);

[Capital IQ](#);

[Lexis/Nexis](#); and

Private Company Information – [Dunn and Bradstreet](#) and [RMA Annual Statement Studies](#)

An excellent source for small and mid-size companies is [RCReports](#).

It is suggested an in-depth interview take place with management. Here is an [example of interview questions](#) from Bannister Financial regarding the firm. Consider

the [IRS sample Information Document Requests in Appendix C](#) of the Job Aid for preparing questions for a compensation study and the article by Stephen Kirkland at the end of this section associated with the Appendices

THREE APPROACHES TO DETERMINING FAIR MARKET VALUE OF REASONABLE COMPENSATION

THE MARKET APPROACH – given the most weight by federal courts.

THE INCOME APPROACH – requires the determination of fair market value at the beginning of the year and the end of the year for application according to the Job Aid. However, the case of [Miller and Sons Dry Wall, Inc.](#) found an exception to this approach and allowed financial statements.

THE COST APPROACH – is generally only used for lower level employees rather than higher income employees.

RECONCILIATION – requires commentary on all three approaches, but in general the market approach is given the most weight.

CLIENT CONCERNS – realize this is not what someone is worth or the value to the firm, but rather what would a third party pay someone to carry out the duties for the position being evaluated.

ADDITIONAL CONCERNS ASSOCIATED WITH LOANS – this is a more complex issue see the Job Aid and the commentary in the text, [Business Valuations and the IRS: Five Books in One](#)

ADDITIONAL CONCERNS REGARDING TAX EXEMPT ORGANIZATIONS – note that

of the seven elements associated with reasonable compensation tax exempt entities include all except stock options. Items included are:

- Wages or Salary
- Fringe Benefits
- Bonuses
- Short Term Incentives
- Long Term Incentives
- Severance Pay
- Stock Options*

(*Note: Not For Profits May Have All Except Stock Options)

JOB AID FOR REASONABLE COMPENSATION

DATE OF ISSUANCE – issued October 29, 2014, but it is still very current.

DEVELOPMENT TEAM – IRS business valuers at the IRS

SECTION 1: PURPOSE, BACKGROUND AND CASE COORDINATION

The purpose of the Job Aid is for IRS Valuation Professionals to have a reference on how to approach this issue. Note that for tax exempt entities Section 4958 Taxes on Excess Benefit Transactions for Not for Profits may come into play.

STEPS TO IDENTIFY REASONABLE COMPENSATION ISSUES – 29 issues from the tax return coupled with an analysis of outside sources of information.

FACTORS RELATING TO THE EMPLOYEE

Arm's Length Relationship

Control by Related Parties

Availability of Comparable Services from a Third Party

Nature of Employees Duties

Employees Background and Experience

Time Devoted to Job

Earnings History of the Employee

FACTORS RELATING TO THE ORGANIZATION

Salary Scale of Others in the Same Line of Business

Size of the Organization

Salary Scale of Employees Generally

FACTORS RELATING TO COMPENSATION ITSELF

Criteria for Compensation

Salary Fixed Many Years in Advance

Substantiation of Duties Performed and Salary Paid

Contingent Compensation

Evidentiary Issues

FACTUAL DEVELOPMENT- is the key

FINANCIAL ANALYSIS - See Appendix D

VALUATION APPROACHES

1. MARKET APPROACH

General Industry Surveys by SIC,
NAICS – See Appendix B

Salary Surveys within the Industry – Trade
Associations, Trade Journals, or Analysts

Proxy Statements and Annual Reports
for Publicly Traded Companies

Private Company Compensation Information
such as Dunn & Bradstreet or RMA

Appendix E Contains an Example of a Market Approach

2. INCOME APPROACH

Requires Fair Market Value of the Company Each Year
with Consideration for Appreciation and Distributions

Independent Investor Test – A Series of Key Court Cases

Calculate Return on Equity Compared
with “Required Rate of Return”

Appendix F Contains an Example of the Income
Approach for Determining Reasonable Compensation

3. COST APPROACH

Many Jobs

How Much Time

Appropriate Compensation for Each

RECONCILIATION

Explain with weight generally to the market approach

SECTION IV: TAXPAYER ARGUMENTS FOR REASONABLE COMPENSATION ISSUES

PRIOR YEARS UNDER-COMPENSATION

In Appendix G Nine Court Cases Presented

In Two Court Agreed Compensation Was
Unreasonable, but Not with IRS Determination

Must meet three criteria:

- The fact of Prior Year Under Compensation
- The Contemporaneous Intent to Compensate for Under-Compensation in a Future Year
- The Specific Amount of the Under-Compensation to Be Compensated for in a Future Year and When that Compensation Will Occur.

INDEPENDENT INVESTOR TEST

See Section III with Investor Demanding a Certain Level of Return

The IRS Valuers Were Involved in the *Guy Schoenecker Inc. v. Commissioner*, T.C. Memo, 1995-539

KEY PERSON / SUPERIOR EMPLOYEE

Often Involves a Company President Who Owns a Significant Portion of Stock

Need to Compare Owner-Employee Compensation with Comparable Non-Owner Employee's Compensation

PERSONAL GUARANTEE OF DEBT

Under the right circumstances "the courts have found that the employee's personal guarantee of the employer's debt is a valid consideration in an overall compensation analysis"

Another Consideration is Whether the Substance is a Contribution of Debt or Equity

INDEPENDENT INVESTOR TEST

See Section III with Investor Demanding a Certain Level of Return

The IRS Valuers Were Involved in the [Guy Schoenecker Inc. v. Commissioner, T.C. Memo, 1995-539](#)

SECTION V: CONSIDERATION OF PENALTIES

This Section Presents Various Code Sections and IRS Procedures for the Consideration of Penalties.

[Code Section 6662](#)

[Revenue Procedure 2012-15](#)

"Beginning in 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."

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

Tax Exempt Entities File a [Form 990](#)

[Code Section 501\(c\)\(3\)](#) Prohibits Inurement and Private Benefit and Limits Compensation to No More Than Reasonable Compensation for Services Performed by its Officers, Trustees, and Employees.

[Code Section 4958](#) Imposes and Excise Tax on Insiders on Compensation that Exceeds Fair Market Value

This may entail a 25% initial tax

200% second tier tax

10% tax on Any Organizational Manager that Knowingly Participated in the Excess Benefit Transaction

Appendix I Illustrates Reasonable Compensation Analysis Using an Example in the Private College and University Sector

APPENDICES

These excellent references include examples. Pay particular attention to sources of data and what the IRS may request in an information document request. Your work should have addressed all of those areas.

Here are some additional source you may find useful. Especially note Stephen Kirkland's article as a recognized national expert in this area:

[Helping S Corporations Avoid Unreasonable Compensation Audits by Stephen Kirkland](#)

[National Council on Non-Profits Commentary on Executive Compensation](#)

[American Hospital Association Compensation Compliance Checklist](#)

[Summary of the Watson Case](#)

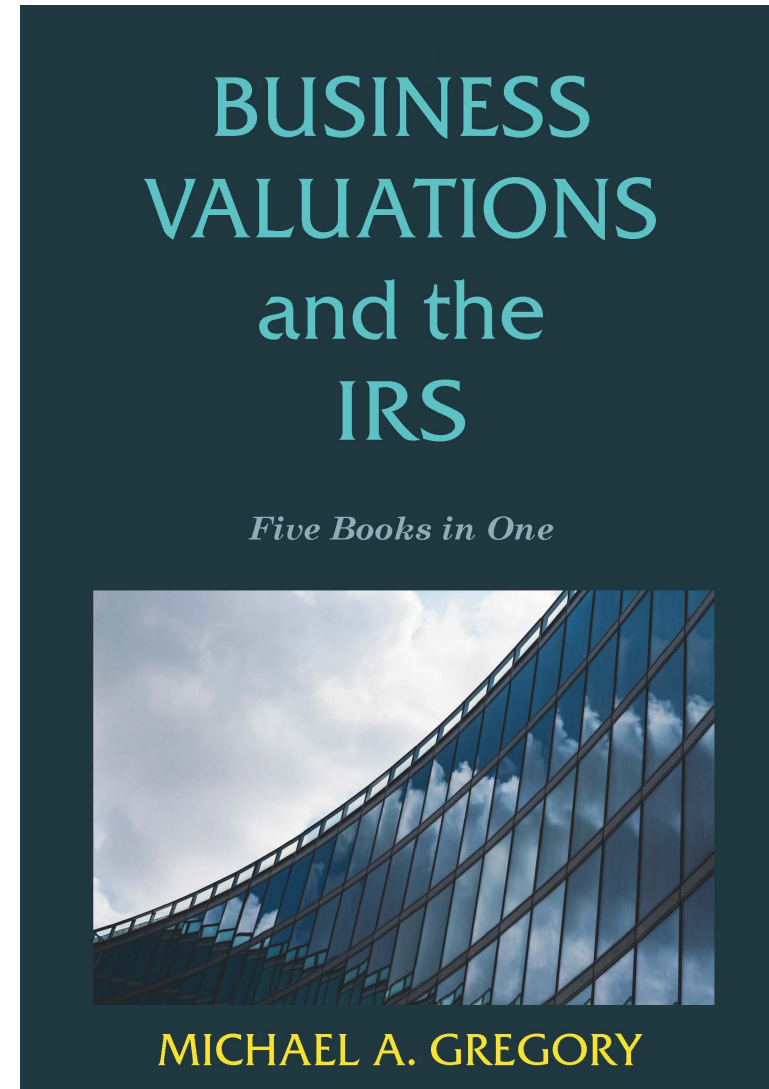
[8th Circuit Findings in Watson Case Appeal](#)

[Awarding Bonuses in Not for Profits](#)

[IRS Exempt Organization Training on Reasonable Compensation](#)

[IRS Colleges and Universities Compliance Project](#)

For a complete, comprehensive, up-to-date discussion of everything discussed in this ebook and in this presentation, order your copy of [Business Valuations and the IRS: Five Books in One](#)



[ORDER THIS BOOK for \\$249 from BVR](#)

BUSINESS VALUATIONS and the IRS:

Five Books in One

by Michael A. Gregory

"The most comprehensive book ever written on business valuation and the IRS"

852 pages, hardcover; \$399 from Amazon.com;
\$249 from Business Valuation Resources

PART ONE: IRS STRUCTURE and PROCESS

Chapter 1 - IRS Culture – Then and Now

Chapter 2 – Understanding IRS Rules of Engagement and How to Use Them

Chapter 3 – Classification at the IRS

Chapter 4 – Working with Valuers and Specialists at the IRS

Chapter 5 – Expert Witnesses and the IRS

PART TWO: RESOLVING CONFLICT WITH THE IRS

Chapter 6 – The Most Common Errors in Appraisals and Ten Golden Rules

Chapter 7 – Issue Resolution and Mediation at the IRS

Chapter 8 – Using the IRS Evaluation Process to Resolve Issues

Chapter 9 – Resolving Conflicts with IRS Teams and Agents with Key Take-Aways

Chapter 10 – Writing a Business Valuation Report for the IRS while Avoiding Penalties

PART THREE: VALUING NON-CONTROLLING INTERESTS IN S-CORPS FOR THE IRS

Chapter 11 - Introduction to S-Corps and the IRS

Chapter 12 - IRS Non-Controlling Interests in S-Corps Job Aid with Commentary

PART FOUR: VALUING REASONABLE COMPENSATION FOR THE IRS

Chapter 13 – Introduction to Reasonable Compensation

Chapter 14 – IRS Reasonable Compensation Job Aid with Commentary

PART FIVE: DISCOUNT FOR LACK OF MARKETABILITY AND THE IRS

Chapter 15 – Introduction to DLOMs and the IRS

Chapter 16 - IRS DLOM Job Aid with Commentary

[To order or to find more information about this book from BVR](#)

BUSINESS VALUATIONS AND THE IRS by Michael A. Gregory

A review by Michael D. Pakter, CPA, CFF, CGMA, CFE, CVA, MAFF, CA, CIRA, CDBV

Business Valuations and the IRS: Five Books in One is the most comprehensive publication ever written for business valuers who prepare appraisals for federal tax purposes. It compiles five books into one with five parts; the first two parts present processes and approaches to resolve conflict, followed by three parts addressing the most common adjustment areas by IRS engineers and valuers.

Part One offers an orientation to IRS organization and culture, IRS official and unofficial rules of engagement, how classification works in general and in business valuations, suggestions for how to work with IRS valuers and specialists, and recommendations for using expert witnesses.

Part Two shows the reader how to resolve issues with the IRS. The most common errors in valuation are presented, followed by strategies for issue resolution and mediation, suggestions for using the IRS evaluation process to resolve issues, strategies for resolving conflicts with IRS teams and agents, and suggestions for writing a business valuation report for the IRS while avoiding potential penalties.

Part Three focuses on S corp valuations and the additional risks associated with S corps. Fifteen items are presented that business valuers should request from clients in every S corp valuation. Recommendations are then offered based on how the IRS approaches S corp valuation issues.

Part Four addresses reasonable compensation. This includes a thorough review and critique of the IRS Job Aid on reasonable compensation as well as its extremely useful appendix. Specific recommendations are presented based on practical experiences with the IRS.

Part Five provides the reader with the most current thinking, ideas, tools, and approaches related to discount for lack of marketability. The IRS Job Aid is presented and

critiqued with the most current thinking by then-current as well as new models used by valuers.

Additional details:

- 181 Practical pointers = 11.5 per chapter, placed at the end of each chapter. These are hands-on.
- 38 Examples (one to four-page real-life stories from Mr. Gregory's actual experiences working with valuation issues in all areas covered by the book)
- 25 Golden suggestions for avoiding/reducing/resolving conflict with the IRS
- 44 Helpful charts photos scattered throughout the book
- 233 Need-to-know IRS terms in a special IRS glossary
- 150 Acronyms for valuation professionals
- Audit Process Chart, Negotiation Process Chart, Negotiation Strategies Chart
- 3 full Job Aids covering the most common areas of valuation friction between taxpayers and the IRS written by original champions with up-to-date commentaries by that same champion plus inputs by many other valuation professionals who were specially solicited for comments for this edition by the author.

In short, this book is a "must-have" book for professionals... Mr. Gregory calls this book "the most comprehensive and up-to-date book on this subject ever written." There is no other book available (or even possible, given his background) which rises to this level of quality and thoroughness in the valuation world.

Michael D. Pakter, CPA, CFF, CGMA, CFE, CVA, MAFF, CA, CIRA, CDBV, NACVA Instructor, and Managing Member of Gould & Pakter Associates, LLC, a Chicago-based CPA, business valuation and litigation support services firm. Mr. Pakter has more than thirty-five years of experience in accounting, forensic accounting, financial analysis, financial forensics, business economics, fraud examinations and investigations, including more than fifteen years of experience in economic damages and business valuations. Courts and arbitral bodies have recognized him as an expert in accounting, financial analysis, financial forensics, economic damages, business valuations and business economics.

[To order or to find more information about this book from BVR](#)