Reasonable Compensation

Job Aid for IRS Valuation Professionals*

*(This Job Aid Can Also be Helpful to Revenue Agents and Other IRS Field Personnel)

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Developed by a Team of IRS Valuation Professionals From the Large Business and International Division

This Job Aid is current as of the original date of issuance only.

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Disclaimer

This Job Aid is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.

This Job Aid is a guide for IRS Valuation Professionals on the Reasonable Compensation issue in Not-for-Profit and For-Profit entities. The Reasonable Compensation issue is factually intensive and must be determined based on all relevant facts and circumstances. The IRS Valuation Professional must first develop all relevant facts and then use professional judgment in choosing appropriate comparables and computing reasonable compensation using applicable valuation approaches.

Although the specific target of this Job Aid is IRS Valuation Professionals, the material in the Aid should be helpful to Revenue Agents and other IRS Field Personnel engaged in identifying and/or developing a Reasonable Compensation issue. It can provide guidance at the risk analysis stage and serve as a template for information collection and analysis.

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SECTION I: PURPOSE, BACKGROUND AND CASE COORDINATION

PURPOSE

The purpose of this Job Aid is to assist IRS Valuation Professionals (Valuation Analysts) in their examination of Reasonable Compensation and to help them to better understand the available approaches. The Job Aid discusses the valuation methods currently used in determining Reasonable Compensation. These methods include the market approach, which is the most commonly used method; the income approach; and, finally, the least used method, the cost approach.

BACKGROUND

The Reasonable Compensation issue usually involves a determination of whether the amount of compensation paid is reasonable so that it is deductible under section 162 of the Internal Revenue Code for income tax purposes. In some cases, the Reasonable Compensation issue comes up when the amount of compensation paid may be lower than reasonable to avoid the payment of employment taxes.[1] For tax-exempt entities, the issue involves the application of section 4958, taxes on excess benefit transactions, and reflects a concern that excessively high compensation may unduly enrich officers, directors, trustees or key employees of the tax-exempt entity at the expense of the qualified charitable purpose.

The Tax Court first considered the "Reasonable Compensation" issue in 1917. Due to the factual nature of the issue, it remains a subject of considerable controversy. Thorough factual development is a key to analyzing the issue.

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[1] According to Treas. Reg. § 1.162-7(a), "The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services."

Treas. Reg. § 1.162-7(b)(3) states, "[T]he allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."

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The courts favor a "market approach" when determining Reasonable Compensation. Under this approach, the determination of the reasonableness of an employee's compensation is made by comparing the employee's compensation with the compensation of employees performing similar duties at similar companies. Ideally, the companies for comparison would be mirror images of the company being analyzed. Due to challenges in matching employees at comparable companies with those of the subject company and in obtaining relevant compensation information for those comparable employees, a number of other approaches have been developed to determine Reasonable Compensation.

CASE COORDINATION

Reasonable Compensation issues often require coordination and consultation within LB&I, and sometimes with other operating divisions and Counsel. Valuation Analysts should appropriately involve the Team Coordinator, Account Coordinator, Principal Revenue Agent, Employment Tax Specialist or other relevant team members in the issue development and/or in the risk analysis to assure that the issue is given a proper priority in accordance with the overall case examination. Conversely, if an audit team is considering a reasonable compensation issue, it is very important that a Valuation Analyst be consulted as part of the issue development. The Compensation and Benefits IPG Subject Matter Experts (SMEs) are available to provide technical assistance and guidance to aid in working through your Reasonable Compensation issues.

APPENDIX A provides a list of suggested readings on the subject of reasonable compensation determinations.

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SECTION II: IDENTIFYING A REASONABLE COMPENSATION ISSUE

CAUTIONS

When first looking at this issue, there are some pertinent cautions and reminders:

1) Reasonable Compensation may be a sensitive issue. The Valuation Analyst’s job is to develop the facts, apply appropriate valuation approaches, and compute the amount of compensation that is reasonable based on all facts and circumstances. Avoid personal judgments about what a specific individual’s efforts seem to be worth to you.

2) The Valuation Analyst should use the term "reasonable" compensation when discussing this issue with the taxpayer. The Analyst’s job is not to tell anyone how much an employee may be compensated. Rather, the Valuation Analyst’s job includes addressing the U.S. Federal tax implications that only a reasonable amount is deductible as compensation.

3) The issue of Reasonable Compensation involves personal and sensitive information, which the Valuation Analyst should carefully protect.

4) What amount constitutes Reasonable Compensation might best be viewed as a range because of the interpretive nature of the issue. Based on the same facts, valuation experts may arrive at various amounts for Reasonable Compensation.

5) Sometimes, high compensation is indicated through comparing the subject’s compensation to that of a commissioned salesperson. If the comparison is valid (i.e., company is in the same industry as the subject company and the subject’s employee is actually doing sales work), then it may not be appropriate to take a position for a lower level of compensation.

6) It is important to conduct a thorough interview with the employee whose compensation is under examination. A good interview reveals the employee’s experience, duties, knowledge, and responsibilities at the company. Failure to interview the employee may result in the taxpayer subsequently presenting facts that the Valuation Analyst did not get a chance to consider. If necessary, a Summons may be used to compel the employee to appear for an interview. An additional option (if needed) is to swear in the employee and prepare an Affidavit containing the employee’s statement under oath.

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WHERE REASONABLE COMPENSATION ISSUES ARE FOUND

Typical cases where Reasonable Compensation issues occur on tax returns are as follows:

1. **FAMILY BUSINESSES**
The Reasonable Compensation issue may arise in a family business. A typical scenario may involve a parent paying a child more than the reasonable worth for the child's services. The business claims a business tax deduction for what should be a gift to the child. The amount of compensation determined to be in excess of what is reasonable for the services actually performed may be disallowed as a deduction, whether the entity is a corporation, sole proprietorship, or partnership. In this instance, there also could be an Estate & Gift (E&G) Tax issue with respect to the excess compensation to a family member as an estate-planning tool.

2. **CLOSELY HELD BUSINESSES**
Reasonable Compensation issues may occur in closely held corporations where employees are also shareholders. A portion of the compensation may in reality be a dividend on stock if the employee is also an owner. This is advantageous to the taxpayer because compensation is a deductible business expense and dividends are not deductible. The income is taxable to the recipient regardless of its classification but different tax rates could apply depending upon the nature of the income.

3. **SUBCHAPTER S CORPORATIONS**
Compensation can be an issue with respect to a corporation that has elected to be taxed under the provisions of Subchapter S. If you have a single owner S corporation and disallow compensation deducted by the corporation, there will be no immediate income tax effect. If there is more than one owner then tax issues could arise as to the proper party or parties to which a disallowed compensation amount should be allocated. The more likely scenario is that a lesser amount will be identified as compensation in order to avoid paying payroll taxes with the remaining amount treated as owner distributions. In these cases, by determining what a proper level of compensation should be, a Valuation Analyst may make the appropriate allocation between amounts subject to payroll tax and amounts not subject to payroll tax.

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4. **FOREIGN CORPORATIONS**
Any time there are foreign operations where wages and salaries are being paid, there can be compensation allocation issues under section 482. International examiners should be consulted on these types of issues.

5. **ACQUISITIONS AND DIVESTITURES/SALES**
In mergers and acquisitions occurring after August 10, 1993, taxpayers may attempt to avoid the 15-year amortization period under section 197 applicable to goodwill and certain intangibles. This may be done, for example, by drafting consulting and/or employment agreements involving large payment amounts that are effective for only a short period of time and that provide entity level deductions. These payment amounts are then carved out of the overall purchase price. Reasonable compensation determinations need to be made to make the proper allocation of purchase price.

6. **ADJUSTMENTS PROPOSED FOR PRIOR YEARS COMPENSATION AMOUNTS**
Sometimes poor financial conditions of a company in prior years may mean the company had to conserve capital and set its compensation levels accordingly. As the company's financial position improves, the company may argue that the officers need to be compensated at a higher level to make up for prior years' under-compensation. Generally, three requirements must be met under these circumstances for a taxpayer to deduct compensation in the current year:

A. Taxpayer must establish the fact of the prior under-compensation.
B. There must be a record of the contemporaneous intent to compensate for under-compensation in future years.
C. The specific amount of the identified under-compensation must be stated.

7. LOANS – NO INTEREST, LOW INTEREST, DISGUISED COMPENSATION
Loans made by entities to its employees may be at no interest or at low interest and the terms may be such that the loan is, in fact, disguised compensation. Loans to individuals exerting control in an entity should be scrutinized to determine if the loan terms are reasonable and are similar to what would be offered by unrelated third parties in the regular course of business. Some factors that are indicative of a bona fide loan include: the existence of a promissory note, cash payments required according to a specified repayment schedule, interest being charged, and security required for the loan in case of default. Beyond the existence of these factors a Valuation Analyst should determine if the loan provisions are indeed being followed and enforced. A Valuation Analyst should also look for loan forgiveness provisions for all or part of the loan. If a Valuation Analyst determines that a loan is a part of the employee's compensation, the amount of the loan must be included in the Reasonable Compensation analysis.

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STEPS TO IDENTIFY REASONABLE COMPENSATION ISSUES

The steps listed below are intended to aid in assessing the magnitude of any Reasonable Compensation issue. From this analysis, it can be determined whether or not it would be a productive use of resources to develop the issue.

No single step is determinative; rather a Valuation Analyst should give consideration to all these items in assessing the issue.

1. **PROCESS FOR SETTING COMPENSATION**

Consider how compensation is determined in the organization. Is there a Compensation Committee or some other specific body charged with determining appropriate compensation levels and is it independent from the individual(s) whose compensation is being set? Is there a requirement for a higher level approval from an independent committee or body, for example, a company's officers or board of directors? Does the company keep contemporaneous records documenting the process for compensation determinations? Are salary surveys or comparables used to help in the determination of appropriate compensation based on an employee's job requirements, education, background, skill levels or other relevant factors? Are the employees for whom compensation is being set in a position to significantly influence the result of the process either directly or through related parties or persons with which they have other business relationships?

2. **TAX RETURN INFORMATION**

It is important to look at an employee's total compensation package. The following items may be considered compensation for Federal tax purposes, but may not be listed on an individual's W-2s:

- Automobile Allowance
- Awards/Prizes Over $25 in Value (Gift Cards or Certificates in Any Amt.)
- Back Pay Awards
- Bonuses - Cash or Noncash
- Cafeteria Plan
- Commissions
- Company Owned or Leased Airplane
- Company Owned or Leased Cars
- Disability Payments
- Discount on Property or Services
- Educational Reimbursements
- Free or Subsidized Lodging
- Golden Parachute Payments
- Life Insurance Over $50,000 in Value
- Low interest loans
- Meal Allowances and/or Reimbursements (when away from home overnight)
- Memberships in Athletic Facilities
- Mortgage, house insurance and Real Property taxes

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- Moving Expenses/Relocation Allowances
- Nonqualified Stock Bonus Plan
- Partnership or S Corporation Distributions
- Pension and Profit Sharing Plans
- Nonqualified Stock Option Plan
- Reimbursements for Loss on Sale of Houses-Job Related Move
- Rent
- Severance Pay
- Scholarships/Fellowships
- Sick Payments
- Vacations (Free or Discounted)

Compensation may be reflected on an employee’s tax return in various ways and appear in various line items. Compensation may be received in cash or property and may not be called salary. For example, besides officers' salaries, compensation has been listed under management fees, consulting fees, covenants not to compete, commissions, legal and professional fees, rent or housing expenses paid, and other. Also, one person's compensation may be listed under more than one account in the general ledger.

There may also be employment tax issues with respect to FICA and withholding on some of the items listed above if such are considered a part of the compensation. A referral to Employment Tax should be considered. A Reasonable Compensation issue that includes the adjustment of a pension and profit sharing deduction requires a referral to Employee Plans. On an individual tax return, Form 1040, look at Schedule C for large amounts of consulting fees, management fees, etc. that could signal a Reasonable Compensation issue for the payee entity.

3. **NUMBER OF EMPLOYEES AT ISSUE**

The people receiving the compensation must be identified. C-Corps (1120) with receipts over $500,000 will provide a breakdown of officer's compensation on Schedule E, "Compensation of Officers." Note that this does not include compensation deducted elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction Simplified Employee Pension Plan (SEP) agreement. For tax-exempt entities, Form 990, Part VII, Section A, requires a listing of the compensation of officers, directors, trustees, key employees, other highly compensated employees and independent contractors. For other tax returns or non-officer compensation, the breakdown must be done through the initial interview and standard IDR requests. For example, an unusually large W-2 or 1099 may signal a Reasonable Compensation issue.

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4. **SALARY SURVEY COMPARISON**
Do a comparison of the compensation with general salary surveys. Most salary surveys show a relationship between entity size and complexity and executive compensation. See APPENDIX B for a listing of general compensation surveys.

5. **SALES COMPARISON**
Look at overall officers' compensation compared to company sales. An issue may exist if the total officers' compensation is higher than the industry averages. As a broad indicator, Officers' Compensation as a percentage of Sales is usually less than 10% at the 90th percentile for a mid-sized or large, mature business. However, this number can vary considerably depending on the industry.

6. **TAXABLE INCOME COMPARISON**
Look at the taxable income on the tax return. Add back the compensation in question. Does it make a significant change in taxable income? For corporations, if most of the profit is taken out of the corporation in compensation, it may indicate a portion of the compensation is a disguised dividend. For tax purposes, Reasonable Compensation is an allowable expense while dividends are not allowed as an expense. Usually, Officers' Compensation divided by Taxable Income (Before NOLs) is less than 1.0 for a mid-sized or large, mature business but will depend on the overall size of the company and standard industry practices. Once again, treat this as a broad indicator and as part of your risk analysis. Officers' Compensation as a percentage of Sales, like Officer's Compensation as a percentage of Taxable Income, can vary considerably, depending on the industry. In general, smaller firms and privately-held firms tend to pay a higher percentage of income as officers' compensation than do larger, publicly-traded firms.

7. **SUBORDINATES COMPARISON**
Look at the relationships between the various salaries paid. For example, in many cases where compensation is independently set, the second in command will have total compensation of 50% to 80% of the CEO's total compensation. If the ratio is considerable lower than this, an issue may exist on the CEO's compensation.

8. **OTHER SURVEY COMPARISONS.**
Other compensation survey information may be available from the taxpayer or other sources. This information should be used in considering whether or not to develop an issue. See Section III of this Job Aid for additional information to request, as well as approaches to developing this issue.

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SECTION III: DEVELOPING REASONABLE COMPENSATION ISSUES

Issue development consists of gathering facts and then analyzing these facts. Financial analysis as well as the standard approaches to performing a valuation (market, income, and cost) are presented here as a way of developing the issue. Determination of reasonable compensation is, at base, a standard valuation problem where what is being valued is an employee's services and the attributes that he or she brings to a company.

WHAT IS REASONABLE COMPENSATION?

Issue development begins with an understanding of what is compensation and what is reasonable compensation. Reasonable Compensation is defined by Treas. Reg. § 1.162-7(b)(3) as the **amount that would ordinarily be paid for like services by like organizations in like circumstances, and this standard is adopted in Treas. Reg. § 53.4958-4(b)(1)(ii)(A).** Thus, the concept has two prongs:

Amount Test – focuses on the reasonableness of the total amount paid; and
Purpose Test – examines the services for which the compensation was paid.

Usually, courts only need to examine the first prong because the inquiry of whether the compensation was reasonable in most instances will subsume the compensatory intent inquiry. However, in some cases, an otherwise reasonable compensation payment may contain a disguised dividend requiring a compensatory intent inquiry apart from the reasonableness inquiry. While noting this "intent is subjective and difficult to prove," *O.S.C. & Assocs. v. Commissioner*, 187 F.3d at 1116, 1120 (9th Cir. 1999), the Ninth Circuit affirmed the Tax Court decision. In this case, the Tax Court disallowed deductions for amounts paid under an incentive contingent compensation contract, without reaching the question of reasonableness, because of the "overwhelming evidence" that the corporation intended to distribute profits rather than pay compensation for services.

EVALUATING THE REQUIREMENTS OF SECTION 162

The reasonableness of compensation paid is a question of fact and each case turns on its own facts and circumstances. In addressing the Reasonable Compensation issue, a Valuation Analyst should consider the following factors (among others that may be relevant in a particular case):

- the employee's qualifications
- the nature, extent, and scope of the employee's duties;
- the employee's background and experience;

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- the employee’s knowledge of the business;
- the size and complexity of the business;
- the time devoted by the employee to the business;
- the economic conditions generally and locally;
- the character and amount of responsibility of the employee;
- whether or not the compensation is pre-determined based on activities to be performed or not determined until the end of the tax year;
- amounts paid to the employee in prior years;
- the salary policy of the taxpayer as to all employees; and
- the amounts paid by similar size businesses in the same area to equally qualified employees for similar services.

These factors are suggested by the provisions of the statute and the associated regulations and have been fleshed out over the years in numerous court decisions. See *Mayson Manufacturing Co. v. Commissioner*, 178 F.2d 115 (6th Cir.1949), See also *Owensby & Kritikos, Inc., v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987).

FACTORS RELATING TO THE EMPLOYEE

Arm’s Length Relationship

This factor is one of the most important ones in evaluating the reasonableness of compensation. A determination must be made as to whether the employer and employee negotiated the compensation at arm’s length. If the negotiation was at arm's length, the risk of excessive compensation is lower. If the negotiation was not at arm's length, the risk of excessive compensation is higher and further factual development may be needed to establish the potential presence of a Reasonable Compensation issue.

Control by Related Parties

It must be determined whether related parties exercise control over the company and, if so, whether the existing relationships are improperly influencing compensation amounts to certain employees. This element is often present in cases involving excessive compensation.

Availability of Comparable Services from a Third Party

Even if the employer could have obtained comparable services at a lower rate from someone other than the employee in question, this factor must then be considered further. The Valuation Analyst’s determination must focus on whether the amount paid to the employee is nonetheless reasonable. This factor often is closely related to a lack of arm’s length transaction.

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Nature of Employee's Duties
The employee's duties are an important factor in determining reasonableness of compensation. If the employee performs highly specialized and skilled tasks, has responsibility for a large volume of work, and/or supervises other employees, he or she may command a higher salary.

Employee's Background and Experience
If an employee is particularly well-qualified for a position because of relevant prior experience, education, or proven expertise in the area, a higher salary might be warranted.

Time Devoted to Job
How much time does the employee devote to the job? Is it the employee's only job? Does the job require an extraordinary commitment of time? On the other hand, does the employee have other jobs that restrict the amount of time available for the position under analysis?

Earning History of the Employee
A large increase to an employee's compensation may indicate unreasonable compensation unless the duties of the employee changed significantly

FACTORS RELATING TO THE ORGANIZATION

Salary Scale of Others in the Same Line of Business
In general, more complex businesses need to pay higher compensation to attract properly qualified personnel. Treas. Reg. § 1.162-7(b)(3) states that, "[i]t is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."

Size of the Organization
A larger organization may pay a higher salary to its employees in reflection of the greater number and difficulty of tasks.

Salary Scale for Employees Generally
Disproportionately high salaries to certain persons may indicate the potential for that compensation to be unreasonable.

FACTORS RELATING TO THE COMPENSATION ITSELF

Criteria for Compensation
An organization's governing body should establish definite criteria for an employee's compensation, clearly spelling out the person's duties, responsibilities and measures of success in the position.

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Salary Fixed Many Years in Advance
One indication that a salary reflects an employee's control over an organization rather than his or her work is that his compensation was established far in advance of the actual performance of services.

Substantiation of Duties Performed and Salary Paid
An organization should keep records indicating the duties performed by its employees and the hours those employees worked. The records will be particularly important if the organization seeks to justify compensation that appears unreasonable based solely on the amount involved.

Contingent Compensation
Treas. Reg. § 1.162-7(b)(2) states that the form of compensation does not determine its appropriateness. In section 162 cases, the courts have focused heavily on the concept of the employee's value to the organization in evaluating the reasonableness of contingent compensation. Although the cases involving tax-exempt organizations do not expressly embrace the section162 analysis of contingent compensation, the reasoning of the cases is quite similar. The focus should be on whether the form of compensation is based on a real and discernible business purpose for the organization.

Evidentiary Issues
Companies have the burden of showing that compensation is reasonable. The courts do not draw an adverse inference from the Service's failure to offer evidence of comparables. However, it is often risky for the IRS to go forward based only on subjective arguments concerning reasonableness. Data on comparability generally requires expert testimony explaining its relevance before it will be given weight by the courts.

FACTUAL DEVELOPMENT

The facts must be thoroughly developed before a Reasonable Compensation issue is raised. Information can be requested by Information Document Request (IDR) or in an interview with the taxpayer. In addition to a functional analysis of the role of the employee in the business, development of the issue also includes conducting a functional analysis of the taxpayer's business, identifying competitors during the interview, and analyzing both the competitor's and taxpayer's businesses in-depth in order to get reasonable and valid comparisons.

APPENDIX C provides sample IDRs. The sample IDRs are intended as a tool for gathering the facts and developing the issue. One or more IDRs may be issued. Examiners should customize IDRs based on the specific facts of the case under examination.

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If working with an LB&I Agent, it should be emphasized that they are responsible for meeting the requirements for issuing IDRs as contained in the LB&I Commissioner's directive issued on November 4, 2013 and effective on March 3, 2014.

FACTORS TO CONSIDER

The courts have developed a number of factors to be considered when determining Reasonable Compensation. For simplicity, these factors can be summarized under five areas.

1. Employee's role in the company.
2. External comparison of the employee's salary with those paid by similar companies for similar services.
3. Character and condition of the company.
4. Conflict of interest in relationship of the employee to the corporation.
5. Internal consistency in the company's treatment of payments to employees.

The above factors should be carefully considered when developing the issue.

See, for example, *Rapco Inc. v. Commissioner*,
85 F.3d 950 (2d Cir. 1996) where the court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue and *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987) where the court also agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue.

FINANCIAL ANALYSIS

Many of the taxpayers' positions in support of high compensation relate to how well the company has performed as a result of the employee's work. In order to determine whether this position has merit, the company's financial performance must be analyzed.

The financial performance of the taxpayer's business must be compared with the industry as well as with similar businesses (competitors). From this perspective, it can be determined whether or not the taxpayer's business is below average, average, or above average. The result of this analysis then provides support for selecting the compensation of the employee being analyzed at the lower, middle, or upper end of a range.

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There are additional reasons why a financial analysis should be done. For example:

- To identify similar companies.
- To explain differences in compensation between competitors based on financial performance.

A detailed explanation of financial analysis is beyond the scope of this Job Aid. Valuation Analysts are trained in this area and should use that training in making the required analysis. It should be pointed out that it is easy to misapply financial analysis. This is particularly true in computing Return on Equity (ROE). See the Income Approach below, as well as the "Hypothetical Independent Investor" discussion in Section IV.

APPENDIX D provides an example of Financial Analysis for a Reasonable Compensation issue.

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VALUATION APPROACHES

The three general approaches to valuation can be applied to Reasonable Compensation in the same way that other appraisals are done. The market, income, and cost approaches are applied and reconciled to determine Reasonable Compensation. The success of all three approaches depends on the level of factual development from interviews, IDR responses, and, where necessary, Summonses.

MARKET APPROACH

When first deciding to pursue the issue of Reasonable Compensation, compare the taxpayer's compensation for the subject employee to compensation within the industry. The market approach begins here and focuses as much as possible on the taxpayer's business and the specific position being analyzed (often the CEO who also owns the business). The question to be answered is: How much compensation would be paid for this same position, held by a non-owner in an arms-length employment relationship, at a similar company?

Listed below are some sources of information for applying the market approach.

1. General Industry Surveys by Standard Industry Code (SIC) and North America Industry Classification System (NAICS). See APPENDIX B for examples.
2. Salary surveys within the industry. See trade organization, trade journals, or analysts study.
3. Proxy Statements/Annual Report for publicly traded companies. These are filings required by the Securities Exchange Commission (SEC). It may be difficult to identify similar companies. If a larger company pays less compensation to a comparable employee, this may be an indication that the taxpayer's compensation is not reasonable. Proxy Statements/Annual Reports can be ordered directly from companies or retrieved from Standard & Poor's Research Insight and Compustat, Capital IQ, Lexis/Nexis, or the SEC website.
4. Private company compensation information. Sometimes private companies disclose compensation records to obtain loans, financing, grants, etc. - Dun & Bradstreet or Risk Management Association.

APPENDIX E contains an example of a market approach.

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INCOME APPROACH

The income approach can only be correctly applied when the Fair Market Value (FMV) of the company is available for each year that compensation is being examined. The FMV of a business entity often changes from year to year and can be a time consuming challenge to determine for any single year. As a result, the market approach is generally more useful than the income approach in a reasonable compensation analysis.

The income approach is based on an "Independent Investor Test," which seeks to determine whether an independent investor would be satisfied with his/her return on investment when looking at the financial performance of the taxpayer's business in conjunction with the subject employee's level of compensation. See *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1325 n.33 (5th Cir. 1987) where the Court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue and *Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Commissioner,* T.C. Memo. 2011-74 (2011).

The Independent Investor Test creates a rebuttable presumption that an employee's compensation is reasonable if investors obtain a far higher return than they had any reason to expect. The rationale behind the Independent Investor Test is that investors pay employees to work to increase the value of the assets entrusted to their management. A high rate of return indicates that the assets' value increased and that the employee provided valuable services. Thus, if investors obtain returns above what they should reasonably expect, an employee's salary is presumptively reasonable. The presumption is rebutted if the high rate of return is attributable to an extraneous event rather than the manager's efforts. Id.

In applying the Independent Investor Test, the total return to the investor is considered, including dividends, stock appreciation and corporate earnings. See *Home Interiors & Gifts, Inc. v. Commissioner, 73 T.C. 1142, 1162 (1980).* The return is then compared to the equity invested to arrive at the annual return on equity. The compensation deduction may be disallowed in part if the corporation does not meet the Independent Investor Test. *B&D Foundation, Inc.,* TC CCH 54,505(M)(2001).

In many cases there is no business valuation available on which to base the return on investment or equity calculation. It is incorrect to simply use the book equity to compute Return on Equity as a proxy for return on investment. Return on Equity can be meaningful with respect to publicly traded companies because the Equity is marked to FMV every day based on the publicly traded price of the stock. With a private or closely-held company, the book equity rarely represents the FMV of the business entity. For example, a private company might have real estate or other tangible assets with higher FMVs than their book values.

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Alternatively, the private company might have unrecorded intangible assets or the owner(s) might have taken excess compensation in the past, all of which would cause the book value to be lower than its fair market value. In such cases, using the book value could artificially inflate the Return on Equity (return on investment).

Assuming that the FMV of the private company can be determined, Return on Equity (return on investment) can then be calculated for any level of compensation and compared against a "Required Rate of Return." This "Required Rate of Return" must be derived for the taxpayer's specific business in the same manner as a discount rate is derived for a discounted cash flow. See the Key Person discussion in Section IV for discussion of the "Required Rate of Return". See also the discussion of The Independent Investor Test under the Income Approach and in Section IV under Taxpayer Arguments. The taxpayer often raises this approach as a defense and applies it incorrectly.

APPENDIX F contains an example of the income approach for determining reasonable compensation.

COST APPROACH

The Cost Approach breaks the duties of the employee into its components such as: company administration, accounting, finance, marketing, advertising, engineering, purchasing, etc. This is usually done via interview or IDR where the total hours worked by the employee are assigned to job functions. Salary surveys are then used to determine the "cost" of each job duty performed by the employee. These are added up to arrive at a total "cost" to replace the duties/ services of the employee.

Taxpayers may claim that the employee performs many jobs and works long hours and therefore is entitled to high compensation. The cost approach breaks the hours spent by the employee down into the various duties performed, quantifies the amount of time devoted to the different responsibilities, and compares the employee’s salary to market compensation for comparable positions. A weakness of the cost approach is that an employee might perform many tasks to some degree. It is often difficult to accurately allocate the employee’s time to each position and it is also difficult to find market salaries for comparable part-time positions. It is inappropriate to add up market salaries of multiple positions on a full-time basis as this would distort the amount of total time actually worked.

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RECONCILIATION

Although standard appraisal practice requires the consideration of all three approaches, the reconciliation in the case of Reasonable Compensation will generally rest heavily on the market approach (comparison to compensation for similar positions in similar companies). The income and cost approaches, as well as financial analysis, are then used to refine the reasonable compensation amount.

SECTION IV: TAXPAYER ARGUMENTS FOR REASONABLE COMPENSATION ISSUES

The taxpayer may rely on one or more of the following five points to support its position as to the appropriate level for current year compensation:

1. Some of the compensation is for prior years' under-compensation.
2. Employee performs multiple jobs.
3. "Hypothetical Independent Investor" test was satisfied.
4. Employee personally guarantees company debt.
5. Employee is a key person at the company or is a superior employee that deserves extraordinary compensation.

Some points to consider in each of these areas are discussed below.

1. PRIOR YEARS UNDER-COMPENSATION

There are three requirements which the courts have suggested are critical to a taxpayer's deduction of compensation for prior years' under-compensation in a current tax year.

The taxpayer must substantiate:

a. The fact of prior year under-compensation (*American Foundry v. Commissioner,* 59 T.C. 231 (1972), *acq*., 1974-2 C.B. 1, *aff'd in part and rev'd in part*, 536 F.2d 289 (9th Cir. 1976));

b. The contemporaneous intent to compensate for under-compensation in a future year (*Perlmutter v. Commissioner*, 44 T.C. 382 (1965), *aff'd*, 373 F. 2d 45 (10th Cir. 1967)); and

c. The specific amount of the under-compensation *(American Foundry*) to be compensated for in a future year and when that compensation will occur.

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Taxpayers often argue that a high level of current compensation is to make up for prior years in which the business was not able to properly compensate an employee. When an employee has, in fact, received inadequate compensation in previous years an increase over what otherwise might be the appropriate compensation level for the current year when taken in isolation may be reasonable. In analyzing this argument, it is necessary to consider the substance of past events in line with the substantiation requirements noted above.

Consider:

- Whether the employee was actually underpaid in prior years based upon their performance?
- Did the company generate enough revenue to make reasonable salary payments in prior years?
- Did the employee as a shareholder enjoy an increase in retained earnings or an increase in the value of the company (for example, through stock options) in lieu of receiving compensation on a current basis (for example, as a salary)?
- Was the employee granted deferred compensation in prior years so that the total compensation paid for those years is reasonable?
- What would have been the effect on the corporate tax rate if a reasonable wage had been paid?

An analysis of all of the prevailing facts and circumstances over time is required to make a proper determination. This can be difficult and resource intensive, especially if a Valuation Analyst has inadequate data due to the passage of time. Remember, the burden is on the taxpayer to substantiate deductions. See, for example, *Nicoll v. Commissioner*, 59 TC 37, 50-51 (1972), *acq.* 1973-2 C.B. 3.

See APPENDIX G for a discussion of court cases relating to prior years' under-compensation.

2. **MULTIPLE JOBS ("MANY HATS"/MANY HOURS)**

Some taxpayers may justify high compensation based on the employees' long hours and the extent of his or her responsibilities. Most high-level employees in a business work longer than a 40 hour work week. *The Officer Compensation Report*, by Panel Publishing, indicates that nearly one third of CEOs work in excess of 60 hours per week during peak times and most work 45 - 60 hours per week even during non-peak times.

The Cost Approach, discussed above under Issue Development, is often a good tool in assessing a taxpayer's position.

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The Service's position on this argument has almost always involved one of these points:

a. Outside interests. See *Estate of Wallace v. Commissioner,* 965 F.2d 1038 (11th Cir. 1992); *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1325 n.33 (5th Cir. 1987) where the Court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered to be reasonable compensation for the years at issue. An employee is entitled to part-time compensation for part-time work.

b. Non-aggregation of roles: functions vs. services (See *Ken Miller Supply, Inc. v. Commissioner,* T.C. Memo. 1978-228) where the Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue. What is important is the nature and the scope of the services performed not the function implied by the job title.

   It is generally expected that a company's top executives will be involved in all aspects of the taxpayer's business and will perform a variety of functions. For example, according to the Occupational Outlook Handbook (United States Department of Labor, Bureau of Labor Statistics, http://www.bls.gov/oco/ocos012.htm), Top executives, including chief executive officers, must devise strategies and formulate policies to ensure that, among other things, the following goals and objectives are met:

   "In small organizations, such as independent retail stores or small manufacturers, a partner, an owner, or a general manager often is responsible for purchasing, hiring, training, quality control, and day-to-day supervisory duties. In large organizations, top executives not only direct the overall organization, but also may be responsible for implementing strategies and setting the overall direction of a certain area of the company or organization."

   The Occupational Outlook Handbook goes on to say that "Top executives are among the highest paid workers; however, long hours, considerable travel, and intense pressure to succeed are

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common." Specifically, "Long hours, including evenings and weekends are standard for most top executives and general managers, although their schedules may be flexible."

c. If a Valuation Analyst assigns compensation for each of the employee's roles, then the Valuation Analyst should determine what fraction of the employee's time is spent on each respective role. The examiner may then assign estimated part-time compensation corresponding to each role.

See APPENDIX H for a discussion of court cases relating to multiple jobs.

3. **PERSONAL GUARANTEE OF DEBT**

Taxpayers may take a position that the employee's personal guarantee for the debt of the corporation is a factor that entitles the employee to a greater compensation level in a current tax year. In certain situations, the courts have found that employee's personal guarantee of the employer's debt is a valid consideration in an overall compensation analysis. See *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987) where the Court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue and *R.J. Nicoll Co. v. Commissioner*, 59 T.C. 37, 50-51 (1972), *acq.* 1973-2 C.B. 3. To determine the relevant facts, the examiner should review the loan agreements.

Another issue in the personal guarantee of debt by officers or shareholders is whether the substance of the transaction involves debt or equity. Re-classification of debt to equity is a highly factual issue and requires extensive factual development. The Valuation Analyst must develop all relevant facts before making a determination that the guaranteed debt should be re-classified as equity and should coordinate the issue with Counsel as early as possible.

4. **INDEPENDENT INVESTOR TEST**

The premise behind an Independent Investor Test is that an independent investor will demand a certain level of return on investment (See prior discussion of the Independent Investor Test in Section III). If the return received is at or above that level, the compensation being paid by the entity is presumptively reasonable, subject to rebuttal by the Service based on an analysis of all of the prevailing facts and circumstances.

In *Guy Schoenecker, Inc. v. Commissioner*, T.C. Memo. 1995-539, the Court found that it was not possible to determine what an "independent investor" would require as a return on an investment given the facts in the case and, as a result,

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the Court diminished the value of the compensation under the independent investor approach. In that case, the Court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue. (Note: IRS valuation personnel were involved in this case to perform an income approach analysis in support of the rebuttal of the taxpayer's position).

5. **KEY PERSON / SUPERIOR EMPLOYEE**

A taxpayer may argue that the employee at issue is a key person, without whom the company would either cease to operate or greatly diminish in value. This argument usually arises in the employee-owner situation (i.e., company president who owns a significant portion of the stock in the company). Generally, in these circumstances, an issue may be present in how the taxpayer allocated payments to the employee-owner between compensation for services rendered (a deductible business expense) and compensation that is a return on capital or investment in the business (a dividend for a C corporation; or a distribution for an S corporation for which no deduction is allowable). In making a determination on reasonableness of compensation paid, a Valuation Analyst should compare the owner-employee's compensation with a comparable non-owner employee's compensation.

SECTION V: CONSIDERATION OF PENALTIES

The Valuation Analyst should consider applying accuracy-related penalties in cases where compensation has been determined to be unreasonable. Section 6662 includes penalties for negligence and substantial understatement of tax liabilities. Historically, these penalties have not been recommended because officers' compensation has been listed as an item that is deemed disclosed under the applicable revenue procedures. However, a listed item will only meet the disclosure standard if taxpayers complete the forms and attachments in a clear manner and in accordance with the instructions. In addition, the dollar amounts entered on the forms must be verifiable. The taxpayer must be able to demonstrate the origin of the amount claimed and show that he entered it in good faith on the applicable form.

Revenue Procedure 2012-15 states, "Form 1120, Schedule E, must be completed when required by instructions." Rev. Proc. 2012-15 was issued to update Rev. Proc. 2011-13. The time devoted to business must be expressed as a percentage as opposed to 'part' or 'as needed.'" In *C.T.I. v. Commissioner*, T.C. Memo. 1994-82, *aff'd,* 1732 A.F.T.R.2d (RIA) 1732 (3d Cir. 1995), the court upheld the substantial understatement penalty in a compensation case where the

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taxpayer had completed the Schedule E using the words "as needed." In this case, the Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue.

The Revenue Procedure does not apply to "golden parachute payments" or to the extent that remuneration exceeds the $1 million limit. In *Thomas A. Curtis, Inc. v. Commissioner*, T.C. Memo. 1994-15, the court upheld both the negligence and the substantial understatement penalties finding that the compensation was excessive and unreasonable, resulting in a partial disallowance of the deduction claimed. Here, the Court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue. Reasonable Compensation is generally determined as a range rather than a specific number. If a taxpayer has paid compensation far above or below a reasonable range based on your valuation, research, and consideration of all relevant facts, you should consider applying penalties.

Beginning with tax year 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. See the Instructions to Form 1125-E for more information.

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

The proceeding sections address Reasonable Compensation issues primarily with a focus on “for-profit” entities. The same concepts generally apply to tax-exempt entities with some special considerations, highlighted in this section. Tax-exempt entities are sometime referred to as “not for-profit” entities or exempt organizations (EOs). These organizations are generally exempt from Federal income taxation under I.R.C. § 501. Exempt organizations file Form 990, Return of Organization Exempt From Income Tax.

Exempt organizations are under the authority of the Exempt Organizations (EO) function of the IRS Tax-Exempt & Government Entities (TE/GE) Operating Division. Thus, in working a Reasonable Compensation issue with an exempt organization, the Valuation Analyst will work with an EO Revenue Agent assigned to the case and may also work with an Employment Tax Specialist and/or an Employee Plans Specialist.

Section 501(c)(3) prohibits inurement and private benefit and, as a result, an exempt organization must pay no more than Reasonable Compensation for services performed by its officers, trustees, and employees. Further, section

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4958 imposes on insiders an excise tax on compensation that exceeds fair market value. Economic benefits provided by exempt organizations and treated as compensation are considered with all other components of the recipient's compensation to determine reasonableness for purposes of the section 4958 excise taxes. Economic benefits that are not treated as compensation may still constitute a section 4958 excess benefit transaction. This is a subject for the TE/GE revenue agent assigned to the case.

Taxable *excess benefit transactions* under section 4958(c)(1) are transactions where the economic benefit provided by an *applicable tax-exempt organization* directly or indirectly to or for the use of any *disqualified person* exceeds the value of the consideration given by the disqualified person, *including performance of services by the disqualified person.* Other excess benefit transactions are statutorily specified for certain transactions with donor advised funds and supporting organizations under
section 4958(c)(2) and (3).

A disqualified person is, with respect to any transaction, a person who, on the date of the transaction or during the five preceding years, was in a position to *exercise substantial influence* over the affairs of the exempt organization. The law imposes an *excise* tax on excess benefit transactions between these disqualified persons and exempt organizations. The excise tax is 25% of the "excess" and is imposed on the disqualified person, not the exempt organization (sections 501(c)(3) or § 501(c)(4)). A manager (officer, director, trustee, or similarly situated person) is subject to a 10% excise tax if the manager knowingly participates in an excess benefit transaction.

If compensation received by a disqualified person is unreasonable (that is, it exceeds fair market value for the services rendered) then that disqualified person is subject to a 25% excise tax (and an additional 200% tax if the transaction is not corrected) on the excess of the compensation.

Taxes imposed by section 4958 include:

- 25% initial tax (paid by disqualified person) on amount of excess (above reasonable consideration) benefit, or the entire amount that is unsubstantiated as compensation,
- 200% second tier tax (paid by disqualified person), if excess benefit transaction is not corrected (i.e., repaid to applicable tax exempt organization with interest) and
- 10% tax on any organization manager who knowingly participated in the excess benefit transaction. This is capped at $20,000 per transaction. The manager is not liable if participation is not willful and is due to reasonable cause.

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A reasonable compensation analysis for the purposes of section 4958 relies upon the principles of reasonableness in the section 162 context that have already been discussed. The Valuation Analyst should work with the assigned TE/GE examiner to assure that all relevant portions of compensation are considered in the analysis. In addition, the Analyst should consider the appropriate population from which compensation comparables should be drawn – should that population include only tax-exempt entities and their employees or should it include taxable entities and their employees as well? This determination will depend upon the facts and circumstances of the case under analysis.

In working a reasonable compensation issue for an exempt organization you may encounter claims of “initial contract exception” or “rebuttable presumption.” It is important to refer such cases back to the assigned TE/GE agents for their consideration because Reasonable Compensation analysis may not be needed in these cases.

APPENDIX I illustrates Reasonable Compensation analysis using an example in the private college and university sector.

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REASONABLE COMPENSATION JOB AID 10/29/2014

APPENDICES

APPENDIX A: SUGGESTED READINGS ON REASONABLE COMPENSATION

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APPENDIX I: EXAMPLE OF NOT-FOR-PROFIT ANALYSIS (UNIVERSITY SECTOR)

APPENDIX A: SUGGESTED READINGS ON REASONABLE COMPENSATION

Publications:

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

Valuing a Business, Shannon Pratt, Irwin Press, 5th Edition (2010)

Financial Valuation: Applications and Models, James Hitchner, John Wiley & Co. (2006)

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

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

Court Decisions Focusing on Methodologies

* *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949)

* *Elliotts, Inc. v. Commissioner,* 716 F.2d 1241, 1245-1247 (9th Cir.1983), *rev'g and remanding ,* T.C. Memo. 1980-282

** *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987)

* *Mad Auto Wrecking v. Commissioner*, T.C. Memo. 1995-153

** *Rapco Inc.* v. Commissioner, 85 F.3d 950 (2d Cir. 1996)

* *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

* *Miller & Sons Drywall v. Commissioner*, T.C. Memo. 2005-114

* *Menard v. Commissioner,* 560 F.3d 620 (7th Cir. 2009)

Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Commissioner, T.C. Memo. 2011-74

Watson v. United States of America, 2012 TNT 36-12

* Service has not acquiesced.
** Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue.

APPENDIX B: DATA SOURCES FOR COMPENSATION ISSUES

Below is a listing of salary surveys and other data sources that have been useful in developing reasonable compensation issues.

Resources presently held by the IRS in 2014, Consult the Engineer Reference Toolkit On-Line for updates or changes. Reference purchases can change on a yearly basis.

1. Watson-Wyatt Salary Survey, Published Annually.
2. RMA Annual Statement Studies, Published by Risk Management Assocs. annually.
3. ERI (Economic Research Institute) Salary Survey, Updated Quarterly*

*Engineer Team 1862 has access to the ERI Salary Survey database and can provide data summaries upon request. Email your requests using secure messaging to: Eisha.M.Sheller@irs.gov, or fax directly to Eisha Sheller at 888-295-5121. You may also fax your requests to Engineer Team 1862 at 216-520-7165 but ***email is strongly preferred.*** Information will be returned to you via email.

If you need a further explanation as to what ERI (Economic Research Institute) is, you may access their website at: www.erieri.com.

For a brief overview of ERI's Executive Compensation database go to: http://www.erieri.com/index.cfm?FuseAction=ERIXA.Main.

Go to http://www.erieri.com/methodologies/xa.pdf for information about ERI's methodology.

It is suggested that the 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. The ERI data is not intended to be the only source of compensation data used in making an excess compensation determination that will be consummated with a proposal for an affirmative adjustment. Rather the examiner should consider and analyze all pertinent reasonable compensation factors when making a reasonable compensation determination.

The role of Engineer Team 1862 is not to interpret or analyze the data, but rather only to gather and compile it with the understanding that the requestor will be using it for risk analysis purposes only.

Current copies of the following sources are not held by the IRS but can often be found at law libraries or libraries with good business reference sections.

4. Top Executive Compensation, Published by the National Industrial Conference Board annually.

5. Executive Compensation and Taxation Coordinator, Published by Research Institute of America (RIA) annually.

6. Almanac of Business & Industrial Financial Ratios by Leo Troy, Published by Prentice-Hall annually.

7. General financial analysis of companies by industry organized by Standard Industry Code.

8. Industry Norms and Key Business Ratios, Published by Dun & Bradstreet Credit Services annually.

There are also various industry specific salary surveys and studies available from trade associations and consulting firms. In using any of these data sources, it is important to know the methodology and background for the collection of the data.

APPENDIX C: INFORMATION DOCUMENT REQUEST SUGGESTIONS

These are examples only and should be customized for your specific taxpayer and facts. Do not simply submit all of these requests unless pertinent to your case.

If working with an LB&I Revenue Agent, it is recommended to emphasize that they are responsible for meeting the requirements for issuing IDRs as contained in the LB&I Commissioner's directive issued on November 4, 2013 and effective on March 3, 2014.

Example 1: This Information Document Request may be issued to explore the role of various officers in the going concern of the enterprise.

Please provide the following information for each officer:

1. The role of the officer, director, trustee or key employee in the organization.

    a. Position(s) held;
    b. Nature, extent, and scope of responsibility;
    c. Duties (Marketing, Logistics; etc.), and hours per week in each discrete job area;
    d. Total hours per week;
    e. Material changes, if any, in each of the above over the last five (5) years;
    f. Copies of employment, consulting and non-compete agreements in effect during the last five (5) years;
    g. Professional qualifications.

2. Results of the officer's efforts.

    a. Officer's stated responsibility for organization's inception and/or its on-going success;
    b. The extent to which the organization's actual success is attributable to the officer independent of his/her official responsibility;
    c. Specific, significant contributions of the officer to the organization and the results of those contributions, both current and past;

3. Does the officer have any other business relationship with the entity other than their official internal role? If so, what is it?

4. If the officer is also shareholder of the company or derives any income as a result of having an ownership interest, provide details as to his/her ownership interest in the company.

5. Does the company carry "Key Person Insurance" on the officer and, if so, what is the amount of that insurance?

Example 2: This Information Document Request may be issued to ascertain information about the character and condition of the enterprise paying compensation to an employee for services performed during the years under examination.

Please provide the following information:

- Please provide copies of the audited financial statements (i.e., income statement, balance sheet, and statement of cash flows) for the organization for the past five years, including all footnotes, addenda, and appendices. If audited statements are not available for any or all of the past five years, please provide copies of the financial statements for book purposes for the past five years.

- Please provide data indicating the average number of employees and the number of employees at year end for each of the past five years.

- Please provide a brief explanation of the activities and functions of your organization. If there have been material changes in these activities and functions during the past five years, please provide a description of these changes. Also please identify your key competitors in the marketplace.

- Please identify and describe local and national economic factors and conditions which are particularly important in affecting the financial condition of your organization. Which of the following would most accurately characterize your organization over the past five years: in expansion mode, stable mode, or downsizing?

- During the past five years, has your organization been subject to or the beneficiary of any extraordinary events? If so, please describe those events and their specific impact on your organization.

Example 3: The purpose of this Information Document Request is to begin gathering information regarding officer compensation and the method of calculating such for use in making comparisons with compensation paid for similar positions in similar entities.

Please provide the following information for each officer:

1. What time of the year was the officer's compensation determined?
2. Were surveys, outside data, or outside expert reports used to determine the compensation amount? If so, please provide the following information:

    a. What sources of data were used for the comparative analysis?
    b. Explain how guideline entities were chosen.
    c. How many entities were included in the survey where the guideline entities were chosen?
    d. Please provide the analysis conducted, i.e. report, summary, etc.

3. Did the compensation involve bonuses? If so, please provide the following information:

    a. Provide the detail formulas for calculating bonus amounts.
    b. How were the formulas derived and who derived them?
    c. Is there any correlation between organizational performance, i.e. the number of new accounts, and officer's compensation? If so, please provide the agreement.

4. Does the officer have access to an organization provided vehicle? If so, please describe the vehicle, the terms of the agreement and provide written documentation if available.

5. Does the officer have extra insurance benefits not available to non-executive employees? If so, please explain the terms in detail and the monetary amount of each.

6. Does the officer have access to any vacation property owned by the organization? If so, what are the terms of the agreement? Were there any transfers of the property during the period under examination that involved the subject individual? If so, was that transfer an arms-length deal made at fair market value?

7. Did the officer receive any loans from the organization? If so, what were the loan terms? Please provide copies of all loan agreements, including any loan modifications.

8. Please provide a summary of the total compensation information for each of the identified officers in the following suggested format:

Officer	Fiscal Year	Base Salary	Bonus	Contribution to Pension and/or Profit Sharing	Other Compensation and Fringe benefits	Total
CEO	Year 1 Year 2 Year 3 Year 4					
2nd in command	Year 1 Year 2 Year 3 Year 4					
3rd in command; Etc.	Year 1 Year 2 Year 3 Year 4					

Example 4: This Information Document request may be issued for the purpose of investigating the independence of the compensation setting process for a relevant employee:

1. If the compensation policy for an employee is available in written form, please provide all versions of that policy that cover the examination period.

2. Who approved the employee's compensation policy? Was the compensation for officers set by the officer(s) or by the board of directors or by some other individuals or groups? Please specify the identity of the approver(s).

3. What is the composition of the board of directors and how was it determined?

4. How are board members elected or selected? If elected, what is the election process and what are the eligibility criteria for voting?

5. Describe whether there are familiar/business relationships among the board members? Among the board members and any of the five most highly compensated officers, trustees or key employees?

6. Are any board members, officers, trustees and/or key employees also board members or officers of any other entity that does business with X? If so, what entity and what is the business relationship of that entity with X?

7. How was the compensation policy determined? Was the policy based on any specific reference sources or by comparison to employees in any other organizations? If so, what references or what comparable organizations were used?

8. When was the employee's compensation determined? Was the policy in force at the beginning of the individual years in the examination period or did it change during the course of one or more years? If it changed when did it change, how did it change and why did it change?

9. Is the compensation of any officers, trustees or key employees based on performance? If so, how is performance measured and how are those measures factored into compensation levels?

10. Provide any and all minutes of board, board committee or organization committee deliberations regarding setting officer(s) or approving compensation.

Example 5: This Information Document Request may be issued to gather information on the relationship of the compensation paid to X, Y and Z in comparison to the compensation paid to other key employees in the organization.

Please provide the following information:

1. Organization Chart - Please provide an organization chart of the entity showing the lines of authority and identifying the responsible persons, their job title, and their area of authority.

2. Employee list - Please provide a list of employees with compensation of more than $XXXXX per year, their job title and annual salary

3. Officers, Directors, Managers - In addition to job title and annual salary, for Officers, Directors, Managers and Key Employees, please provide the following:

    a. Description of duties and responsibilities.
    b. Number of direct reports.
    c. Amount of time devoted to job.
    d. Summary of background and experience including any other jobs held in the past 5 years.
    e. Copy of employment contract.

APPENDIX D: FINANCIAL ANALYSIS - EXAMPLE

In this example, the subject company's financials will be compared using the Risk Management Association (RMA) data.
Search the NAICS code that matches the subject company's industry.

Subject Company Income Statements	Fiscal year Ending mm/dd/yyyy	As a % of Sales
Net Sales	$62,189,729	100.00%
Cost of Sales	$54,848,901	88.20%
Gross Profit	$7,340,828	11.80%
Operating Expenses		
Selling, General & Admin Expenses	$5,453,859	8.77%
CEO Salary	$1,425,000	2.29%
	$6,878,859	11.06%
Operating Income	$461,969	0.74%
Other Income (Expense)	($369)	0.00%
Income Before Taxes	$461,600	0.74%
Provision for Taxes	$184,739	0.30%
Net Income	$276,861	0.44%

Subject Company Balance Sheet	Fiscal Year Ending mm/dd/yyyy	Percentage
Assets:		
Current Assets	$3,300,913	72.32%
Other Investments	$171,151	3.75%
Property, Plant and Equipment	$1,092,265	23.93%
Total Assets:	$4,564,329	100.00%

Liabilities & Stockholders' Equity:		
Current Liabilities	$3,761,737	82.42%
Long-term debt	$83,723	1.83%
Total Liabilities:	$3,845,460	84.25%
Preferred Stock	$230,000	5.04%
Common Stock	$15,800	0.35%
Additional Paid-In Capital		0.00%
Retained Earnings	$473,069	10.36%
	$718,869	15.75%
Less Treasury Stock		0.00%
Total shareholders' Equity	$718,869	15.75%
Liabilities + Stockholders' Equity:	$4,564,329	100.00%

Calculation of ratios:	Fiscal Year Ending mm/dd/yyyy
Sales growth (decline)	9.8%
Income, operations growth (decline)	76.8%
Profit before taxes growth	85.9%
CEO salary growth (decline)	43.5%
Retained earnings growth	78.8%
Net worth (equity) growth	40.8%
Gross profit/net sales	11.8%
Operating profit/net sales	0.7%
Profit before taxes/net sales	0.7%
Current ratio	0.88
Debt/worth (total liab./owner's equity)	5.35
% Profit before taxes/tangible net worth	64.2%
% Profit before taxes/total assets	10.1%
Sales/total assets	13.63
% officers' comp/sales	2.3%

RMA Data:

	RMA Data	Taxpayer Ratio	Taxpayer vs. RMA Data	
Total Liab.as % of (Liab+Equity)	67.20%	84.25%	17.05%	Unfavorable
Net Worth as % Total Assets	32.80%	15.75%	-17.05%	Unfavorable
Gross Profit/Net Sales %	16.30%	11.80%	-4.50%	Unfavorable
Operating Profit/Net Sales %	1.90%	0.74%	-1.16%	Unfavorable
Profit Before Taxes/Net Sales %	1.80%	0.74%	-1.06%	Unfavorable
Current ratio				
Upper quartile	1.6		-0.7	
Median	1.2	0.9	-0.3	Lower than median
Lower quartile	1.0		-0.1	
Debt/Worth (Tot. Liab/Owner's Equity)				
Upper quartile	1.2		4.1	
Median	2.4	5.3	2.9	Higher than median
Lower quartile	5.6		-0.3	
% Profit before taxes/tangible net worth				
Upper quartile	36.30%		27.91%	
Median	23.10%	64.21%	41.11%	Favorable
Lower quartile	10.80%		53.41%	
% Profit before taxes/total assets				
Upper quartile	13.40%		-3.29%	
Median	8.40%	10.11%	1.71%	Higher than median
Lower quartile	1.90%		8.21%	
Sales/Total Assets				
Upper quartile	7.4		6.2	
Median	5.2	13.6	8.4	Favorable
Lower quartile	3.7		9.9	

RMA Data:

	RMA Data	Taxpayer Ratio	Taxpayer vs. RMA Data	
% Officers', Directors', Owners' Comp/Sales				
Upper quartile	0.90%		1.39%	
Median	1.50%	2.29%	0.79%	Unfavorable
Lower quartile	2.40%		-0.11%	

Based on this comparison, taxpayer's financial ratios are weaker. Taxpayer may be under-capitalized.

After further factual development, the equity level may be increased and the CEO salary may be adjusted to bring taxpayer's financial ratios in line with the industry.

Note: This is just an example. RMA does not recommend using its data as absolute norms for a given industry. The officers, directors, owners' compensation/sales ratio "include total salaries, bonuses, commissions, and other remuneration to all officers, directors, and/or owners of the firm during the year covered by the statement".[1]

[1] *The Risk Management Association annual statement studies Financial Ratio Benchmarks 2010, 2011* page 20.

APPENDIX E: MARKET APPROACH - EXAMPLE.

Comparisons were made between taxpayer and 10 guideline companies. The guideline companies are assumed to be reasonably comparable to the taxpayer's business.

Company	Total Sales ($million)	Profit ($mil)	Profit % of Sales	Return on Assets	Return on Equity	Officer's Compensation	(as %) Officer's comp/ Sales	(as %) Officer's comp/ Profit
Comparable 1	$538.4	$30.2	5.6%	15.3%	18.2%	$649,209	0.12%	2.14%
Comparable 2	$1,621.5	$50.3	3.1%	6.6%	16.1%	$1,110,730	0.07%	2.21%
Comparable 3	$1,991.0	$59.7	3.0%	4.2%	6.2%	$1,070,392	0.05%	1.78%
Comparable 4	$605.4	$23.0	3.8%	7.4%	11.5%	$528,636	0.09%	2.28%
Comparable 5	$2,238.7	$20.1	0.9%	3.3%	12.1%	$760,182	0.03%	3.86%
Comparable 6	$405.1	$10.5	2.6%	3.6%	9.7%	$204,731	0.05%	1.93%
Comparable 7	$662.6	$84.2	12.7%	20.9%	24.8%	$550,000	0.08%	0.65%
Comparable 8	$895.3	$17.9	2.0%	6.8%	16.3%	$799,366	0.09%	4.39%
Comparable 9	$541.5	$15.2	2.8%	4.7%	8.8%	$655,750	0.12%	4.26%
Comparable 10	$418.5	$0.4	0.1%	0.0%	0.1%	$364,000	0.09%	182.00%
Average	$991.8	$31.2	3.7%	7.3%	12.4%	$669,300	0.08%	20.55%
Median	$634.0	$21.6	2.9%	5.7%	11.8%	$652,480	0.09%	2.25%
Taxpayer:	$36.2	$0.5	1.4%	1.2%	19.1%	$1,200,000	3.32%	240.00%
Taxpayer vs. Comparables	Smaller		Worse	Worse	Better		Higher	Higher

The above example indicates that the taxpayer was at a weaker financial position than the comparable companies. The officer compensation might be in excess. Adjustment to the compensation could be made to bring the ratios in line with the industry and the competitors.

In this example, only limited data were used. In practice, a more detailed financial review should be performed. Financial ratios may include but not be limited to profitability ratios, efficiency ratios, liquidity ratios, solvency ratios, etc. The ratios can be used to assess whether the taxpayer's financial performance is stronger, similar, or weaker as compared to the industry and competitors.

Financial information for prior years of the taxpayer, competitors, and industry can assist in determining whether or not the taxpayer is having a "typical" year or one which has been "exceptional", in either a positive or a negative direction.

In this example, the taxpayer is much smaller than the public comparable companies. This is typical in that it is difficult to get public information for small companies.

Return on equity is presented in this example. Be aware that the taxpayer's book equity must be adjusted to the fair market value which is often not available for private companies. Return on equity will not be meaningful if the book equity does not reflect fair market value. See the Income Approach for further discussion.

APPENDIX F: INCOME APPROACH - EXAMPLE.

In this example, the sole-shareholder of the taxpayer company is also the CEO. It is assumed that the fair market value of the company is known at the beginning and at the end of each year.

	Year 1	Year 2	Year 3	Year 4
Sales:	110,000,000	115,000,000	118,000,000	113,000,000
Net cash flow:	4,100,000	4,280,000	4,460,000	4,990,000
Dividend:	100,000	100,000	150,000	100,000
CEO compensation:	2,200,000	2,500,000	2,700,000	2,800,000
Fair Market Value (FMV) of the company				
Beginning of the year:	14,000,000	16,000,000	19,000,000	20,000,000
End of the year:	16,000,000	19,000,000	20,000,000	20,000,000

Required rate of return is assumed to be 20%; a return that a "hypothetical independent investor" would expect based on comparisons with public company competitors and industry expectations.

NOTE: How to develop a required rate of return is beyond the scope of this example.
Please contact an engineering specialist for assistance in developing a required rate of return.

The following worksheet uses taxpayer’s compensation and financial information to compute the return on equity. The return is then compared with what a "hypothetical independent investor" would require as return on equity.

The investor's return, in this example is from appreciation and dividends.

	Year 1	Year 2	Year 3	Year 4
FMV of stock:				
Beginning of year	14,000,000	16,000,000	19,000,000	20,000,000
End of year	16,000,000	19,000,000	20,000,000	20,000,000
Appreciation	2,000,000	3,000,000	1,000,000	0
Dividends	100,000	100,000	150,000	100,000
Return	2,100,000	3,100,000	1,150,000	100,000
Company annual % return	15%	19%	6%	1%
Investor required % return	20%	20%	20%	20%

Notes: Annual % return is computed using the annual investor's return and the beginning year FMV:
(e.g. year 2 Annual % Return = 3,100,000 / 16,000,000 = .1938 = 19%.

The calculation indicates that a hypothetical independent investor's return in the company is lower than 20%, the required rate of return. This addresses the "hypothetical independent investor" as raised in *Elliotts v.Commissioner*, 716 F.2d 1241, 1245-1247 (9th Cir. 1983), reversing and remanding T.C. Memo 1980-282.

APPENDIX G: COURT CASES RELATING TO PRIOR YEARS' UNDER-COMPENSATION

Under-compensation for prior years is a common organizational defense for high current year compensation

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Estate of Wallace v. Commissioner, 965 F.2d 1038 (11th Cir. 1992)

American Foundry v. Commissioner, 59 T.C. 231 (1972), *aff'd in part and rev'd in part,* 536 F.2d 289 (9th Cir. 1976), *acq.* 1974-2 C.B. 1

Perlmutter v. Commissioner, 44 T.C. 382 (1965), *aff'd*, 373 F.2d 45 (10th Cir. 1967)

* *R.J. Kremer Co. v. Commissioner*, T.C. Memo. 1980-69

Dixo Co., Inc. v. Commissioner., T.C. Memo. 1968-133, *acq.* 1969 AOD LEXIS 337

Pacific Grains, Inc. v. Commissioner, T.C. Memo. 1967-7, *aff'd,* 399 F.2d 603 (9th Cir. 1968)

Nelson Brothers, Inc. v. Commissioner, T.C. Memo. 1992-726

* *Standard Asbestos Manufacturing v. Commissioner*, T.C. Memo. 1958-42, *aff'd in part and rev'd in part,* 276 F.2d 289 (8th Cir. 1960)

Willmark Service System, Inc. v. Commissioner, T.C. Memo. 1965-294, *aff'd,* 368 F.2d 359 (2d Cir. 1966)

* Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue.

APPENDIX H: COURT CASES RELATING TO MULTIPLE JOBS ("Many Hats")

Employee performing multiple jobs within the organization is a common organizational defense for high compensation levels.

Estate of Wallace v. Commissioner, 965 F.2d 1038 (11th Cir. 1992)

* *Dockery v. Commissioner*, T.C. Memo. 1982-509

* *Richlands Medical Association v. Commissioner*, T.C. Memo. 1990-660, *aff'd,* 953 F.2d 639 (4th Cir. 1992)

* *Ken Miller Supply v. Commissioner*, T.C. Memo. 1978-228

* *C.A. White Trucking v. Commissioner*, T.C. Memo. 1977-6, *aff'd,* 601 F.2d 867 (5th Cir. 1979)

* *Hendricks Furniture v. Commissioner*, T.C. Memo. 1988-133

* Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue.

APPENDIX I: EXAMPLE OF A NOT-FOR-PROFIT ANALYSIS (UNIVERSITY SECTOR)

The following discussion illustrates the approach to analyzing compensation issues in the tax-exempt sector using the example of private colleges and universities. For these issues, the IRS Valuation Analyst works closely with the assigned TE/GE examiner. In addition, an Employment Tax Examiner or an Employee Plans Agent or both should be considered for the Exam team. The Valuation Analyst focuses on reasonable compensation while the other examiners consider other aspects of compensation having potential tax ramifications.

EXAMINATION PLANNING

Reasonable Compensation Determinations

The valuation approaches to establishing reasonable compensation for tax-exempt entities are the same as those used for taxable entities: the market, the income, and the cost approaches. These approaches are applied and then reconciled to determine Reasonable Compensation.

A prototypical examination plan for a reasonable compensation issue may include the following steps:

1. Plan on preparing a complete compensation analysis using as many data sources and analysis approaches as is feasible, with a minimal reliance on summary figures from databases.
2. Consider the appropriate market population for tax-exempts; generally speaking, we would start with both taxable and tax-exempt comparables (which is expressly permitted in the Treas. Reg. § 53.4958-4(b)(1)(ii)(A)) and make an appropriate decision as to what comparable set is most appropriate for the specific facts and circumstances.
3. Reference the most reasonable of comparables, striving for at least 5 comparables if possible; comparables must consider both the position being evaluated (actual activities performed) and the entity in which the position exists.
4. Make appropriate adjustments to the comparable data to reflect the subject and to fully explain the logic of those adjustments.
5. Perform some type of a multi-factor analysis such as that of the 5th Circuit in *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987) (Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue).
6. Consider the viewpoint and the financial requirements of an independent investor as was done by the 2d Circuit in *Rapco Inc.* v. Commissioner, 85 F.3d 950 (2d Cir. 1996) (Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue).
7. Focus on total compensation rather than its individual parts as was made clear by the 5th Circuit in *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987) (Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue).
8. Avoid analyzing isolated time periods without considering long-term patterns, especially where a bonus plan is in place. *See Dexsil Corp. v. Commissioner*, 147 F.3d 96 (2d. Cir. 1998) (Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue).

9. Stay objective and resist the temptation to offer subjective opinions. *See Dexsil Corp. v. Commissioner*, 147 F.3d 96 (2d. Cir. 1998) (Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue); *Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Commissioner,* T.C. Memo. 2011-74.

Potentially Taxable Fringe Benefits & Authorities

College and university executives may receive funds in many different forms including wages, bonuses, service awards, scholastic awards, and honoraria, as well as non-monetary compensation such as services or property. For many university presidents, as a condition of their employment and contained within their employment contracts, there is the **requirement** they live in the president's mansion and use a university-provided vehicle. If these are requirements of their employment, then these fringe benefits are not taxable and are not reported on their W-2s. Other fringe benefits may be taxable and need to be considered both as part of the overall analysis and in isolation to make sure that the proper tax treatment is being applied. Some areas to consider in examination planning are the following:

Country Club Membership:
I.R.C. §§ 61, 162(a), 274(a)(3) and (d)(2), 132(d)
Treas. Regs. §§ 1.274-2(a)(2) and 1.132-5(s)

Employer Provided Vehicle:
I.R.C. §§ 61, 274(d)(4) and 132(d)
Treas. Regs. §§ 1.61-21(d) and 1.132-5(b)

Group Term Life Insurance (Premium on Insurance> $50K):
I.R.C. § 79(a)

University Provided Housing & Authorities:
I.R.C. § 61; Treas. Reg. § 1.61-21(a)(1) – Generally included in gross income.
I.R.C. § 119(a) – Excludes meals or lodging furnished for the convenience of the employer.
I.R.C. § 119(d) – Excludes qualified campus lodging.
I.R.C. § 119(d)(2) provides an exception for inadequate rent.
I.R.C. § 119(d)(3) defines qualified campus lodging.

Athletic Coach Sports Camps:
The fair rental value of certain athletic facilities (football, soccer, or baseball fields; basketball courts) provided to coaches at no charge may be included in their compensation.
I.R.C. §§ 61, 3401(a), 3306(b) and 3121(a)
Treas. Regs. §§ 1.61-1, 31.3121(a)-1(e), 31.3401(a)-1(a)(4) and 31.3306(b)-1(e)

I.R.C. § 4958 considerations:
Athletic coach may not be a disqualified person (DP) subject to I.R.C. § 4958

Severance Payments and Authorities:
I.R.C. § 3121(a) – defines the term wages to mean all remuneration for employment

Treas. Reg. § 1.3121(a)-1(i) – remuneration for employment, unless such remuneration is specifically excepted under I.R.C. § 3121(a) or Treas. Reg. § 31.3121(a)-1(j), constitutes wages even though at the time paid, the relationship of employer and employee no longer exists.

Rev. Rul. 74-252, 1974-2 C.B. 287, holds that all payments made by an employer to an employee on account of involuntary separation from the service of the employer are wages for purposes of the FICA, the FUTA, and federal income tax withholding.

Mayberry v. United States, 151 F.3d 855, 860 (8th Cir. 1998): Found that a settlement award received by a former employee constituted wages. Opinion refers to § 3121(b): "Employment means any service, of whatever nature performed . . . by an employee for the person employing him . . . ." The courts have taken the position that termination payments and payments made by employers to former employees are wages for employment tax purposes in numerous cases: for example, *Associated Electric Cooperative, Inc. v. United States*, 226 F.3d 1322 (Fed. Cir. 2000) (payments to employees under a voluntary "early out" plan were wages subject to FICA taxes); *Abrahamsen v. United States*, 228 F.3d 1360 (Fed. Cir. 2000) (payments made under an employer's exit-incentive programs were wages subject to FICA taxes); *Hemelt v. United States*, 122 F.3d 204, 209-10 (4th Cir. 1997) (compensation for lost wages was subject to FICA taxes); *Gerbec v. United States*, 164 F.3d 1015, 1025-27 (6th Cir. 1999) (settlement award representing a loss in back wages and future wages that otherwise would have been paid was wages for FICA purposes).

Severance Payments – Contract Cancellations:
Revenue Ruling 2004-110, 2004-2 C.B. 960: An amount paid to an employee as consideration for cancellation of an employment contract and relinquishment of contract rights is ordinary income, and wages for purposes of FICA, FUTA, and Federal income tax withholding.

Severance Payments – Tenure Buyouts:
University of Pittsburgh v. United States, 507 F.3d 165 (3d Cir. 2007): Tenure buyouts to university professors are wages for FICA tax purposes. *But see North Dakota State University v. United States*, 255 F.3d 599 (8th Cir. 2001), *nonacq.,* AOD 2007-01, holding that tenure buyouts to university professors are not wages for FICA tax purposes. AOD 2007-01: The Service will follow *North Dakota State University* only within the Eighth Circuit and only with respect to cases that have the exact facts as that case and only to the extent that payments were made before January 12, 2005.

Tuition Waivers:
I.R.C. § 117(d) excludes any *qualified tuition reduction* from income, defined as:
The amount of any reduction in tuition provided to an employee of an organization described in I.R.C. § 170(b)(1)(A)(ii) for education below the graduate level at such organization or another organization described in I.R.C. § 170(b)(1)(A)(ii).

For the employee or any person treated as employee under the provisions of I.R.C. § 132(h), I.R.C. § 117(d)(3) describes the non-discrimination rules applicable to highly compensated employees. *See* PLR 9621033 (Feb. 26, 1996).

Tuition Waivers – Exception:
Graduate students engaged in teaching or research activities for an educational organization described in I.R.C. § 170(b)(1)(A)(ii) may also exclude reduction in tuition at that educational organization under I.R.C. § 117(d).

I.R.C. § 127(a) excludes from gross income the first $5,250 of employer-paid expenses under an educational assistance program for employees. This $5,250 is in addition to amounts excluded under I.R.C. § 117(d). *See* I.R.C. § 127(c)(6).

See Revenue Ruling 86-69, 1986-1 C.B. 78, finding the provisions of I.R.C. § 117(d)(1) and I.R.C. § 127(a) to be independent, and amounts not excluded under I.R.C. § 127(a) may be excluded under I.R.C. § 117(d)(1).

Tuition Waivers - Authorities and Rulings:
I.R.C. § 117(d)
I.R.C. §§ 127(a), 132(j)(8), and 132 (l)
PLR 9040045 (July 10, 1990)
FSA 200231016 (Mar. 13, 2002)

Graduate Tuition Waivers, Remissions, or Reductions - Free or discounted graduate level tuition offered to the employees of educational organizations. Audit techniques for graduate tuition issues include: Identifying names of students who received graduate tuition benefits, determining students' titles and job descriptions, and the amounts of tuition fees waived.

Specific Issues/Concerns with Loans

Loans - No Interest, Low Interest or Disguised Compensation: Loans may have been at no interest or low interest and, in some instances, the terms have been such that the loan is disguised compensation. This issue can occur in both Not-for-Profits and For-Profits. Some factors that are indicative of a bona fide loan include: the existence of a promissory note, cash payments according to a specified repayment schedule, interest charged, and security for the loan.

Loans to executives should be reviewed to determine if they are bona fide and to determine if the terms are being followed.

- Is there a written document detailing the terms of the loan, such as a formal repayment schedule?
- Is repayment required over a certain number of years or on demand?
- Is the interest rate at market or at a below market rate of interest?
- Is the loan listed on the entity's balance sheet as a receivable?
- Are the terms of the loan being followed? For example, are payments being made monthly? Is the executive making payments?, etc.

The loan terms could include forgiveness of part or the entire loan if the executive remains with the entity for a certain number of years, etc. Such arrangements may constitute compensation income rather than bona fide loans.

I.R.C. § 7872 deals with the treatment of loans having interest rates, that are below the prevailing market rate as of the date of the loan. It specifically applies to compensation-related loans, which include below market loans directly or indirectly between an employer and an employee. In general, § 7872 operates to impute interest on below market loans. In the case of employer/employee loans, the employer is treated as transferring the forgone interest to the employee as additional compensation and the employee is treated as paying interest back to the employer.

Different rules apply depending on whether a loan is a demand loan (§ 7872(a)) or a term loan (§ 7872(b)). A demand loan is a below-market loan if it does not provide for an interest rate at least equal to the applicable federal rate. A term loan is a below-market loan if the present value of all amounts due on the loan is less than the amount of the loan (i.e., the yield to maturity is lower than the applicable federal rate).

Demand Loans: With respect to demand loans, the imputed interest payments and deemed transfers of additional compensation are treated as transferred on the last day of the calendar year.

Term Loans: With respect to term loans, the lender is treated at the time of the loan as transferring the difference between the loan amount and the present value of all future payments required under the loan as additional compensation. The term loan is then treated as having original issue discount (OID) equal to the amount of the deemed transfer of additional compensation and thus, subject to the OID provisions of § 1271 et seq.

There is a de minimis exception from the application of the § 7872 imputation rules for compensation-related loans if all loans between the parties in the aggregate for any day do not exceed $10,000 (§ 7872(d)(3)). The de minimis exception does not apply if one of the principal purposes of the loan is tax avoidance.

There are also a number of exemptions from the application of § 7872 for loans listed in Treas. Reg. § 1.7872-5T – Exempted Loans.

Personal loans to officers and directors of public companies are banned by the Sarbanes-Oxley Act of 2002, which became effective on July 30, 2002. Personal loans outstanding on the date of enactment are not prohibited, provided there is no material modification or renewal of the loan on or after the date of enactment. Neither loans nor an extension of credit can be renewed after the date of enactment of Sarbanes-Oxley. This law does not apply to private companies.

Some loans to executives are essentially disguised compensation based on the terms of the loan. I.R.C. § 61(a)(1) and § 61(a)(12) define gross income to include compensation for services and income from discharge of indebtedness.

Treas. Reg. § 1.61-12(a) provides that if an individual performs services for a creditor, who in consideration for the services cancels the debt, the debtor realizes income in the amount of the debt as compensation for services. Discharge of indebtedness income realized by an employee from an employer under these circumstances is payment in the nature of compensation, and thus is includible in gross income and wages for employment tax purposes.

Issues have been raised regarding loan forgiveness. For example, loans may be forgiven if the employee remains in the employ of the entity for a certain period; loans may call for unusual repayment methods, such as stock in lieu of cash, and extreme repayment dates, such as repayment by the executive's trust upon the death of the executive and his spouse. Whether these arrangements should be considered bona fide loans depends on the specific facts and circumstances.

See Winter v. Commissioner, T.C. Memo 2010-287 (bonus advance held compensation for services).

EXAMINATION CONDUCT AND COORDINATION

It is essential that the assigned examiners work together throughout the examination process to assure that all relevant compensation items are being considered and that such are being consistently treated. If an item is compensatory in nature it should be part of the reasonable compensation analysis. Even though overall compensation, including all such items, may ultimately be deemed reasonable the tax treatment of individual items may still require adjustment. On-going communication and collaboration are critical factors in seeing that a comprehensive compensation examination is performed. If one examiner uncovers an item of a compensatory nature this information should be immediately shared with all other assigned examiners so that it can be appropriately considered in all of the analyses. The Compensation and Benefits IPG Subject Matter Experts (SMEs) are available to provide technical assistance and guidance to aid in working through your Reasonable Compensation issues. The Valuation Analyst cannot work in isolation and be confident that a proper reasonable compensation determination has been made.