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Reasonable Compensation Simplified™

Reasonable Compensation: The New Elephant in the Room

In late December of 2017, the most significant piece of tax legislation since the Tax Reform Act of 1986 was signed into law (Brady, 2017). Dubbed the "Tax Cuts and Jobs Act of 2017" (TCJA), the legislation not only made minor reductions to most individual tax brackets and major reductions for corporate tax brackets, but it also complicated much of the existing laws, particularly around closely held corporations or S Corps (IRS, 2018b). One element which was modified for S Corps, in particular, was the impact of reasonable compensation on the S Corp owner's personal tax return. This paper examines why the IRS is now focusing on reasonable compensation, how the TCJA has intensified the need for an accurate reasonable compensation figure, and how reasonable compensation can be derived properly.

A Renewed Focus

Reasonable compensation has been an issue for S Corp officers virtually since their inception. The challenge comes from the often dual role held by owners of S Corps as both a corporate officer and an employee. The IRS code makes it clear that an officer of an S Corp is considered an employee of that corporation, primarily for purposes of Federal Employment Taxes (IRS, 2018b). As an employee, an officer needs to be compensated for their work and should be paid a wage. Some try to avoid this by regarding S Corp owner's compensation as distributions rather than wages. However, this will often draw IRS scrutiny and may result in an audit.

In 1974 the IRS issued a ruling stating that if an officer or shareholder fails to take a salary, or if that salary is considered unreasonable, an auditor should shift that officer's distributions to account for reasonable compensation (Small Business Association of Michigan, 2019). This will make the compensation subject to traditional taxes on wages, such as Social Security tax, Medicare, Federal Unemployment Tax, and the state tax in which the S Corp resides. Having been enforced in one manner for more than 40 years has led many tax professionals to have a set perspective on how to calculate reasonable compensation. The introduction of the TCJA, however, has caused confusion and difficulty for tax professionals in figuring reasonable compensation. Likewise, the IRS has a renewed focus on reasonable compensation figures due to the importance of accurately calculating such a number. Why has this occurred? One specific deduction holds the answer.

199A

Also known as the Qualified Business Income (QBI) deduction, the Section 199A deduction has caused massive confusion on the part of business clients and tax professionals alike. Troublingly, the 199A deduction operates with a type of circular logic that the IRS, business clients, and tax professionals find confusing.

At its core, the 199A deduction relies on the S Corp's profit and the taxable income of the taxpayer as reported on their 1040 (including the W-2 income, also known as reasonable compensation). Any change to the S Corp's income or reasonable compensation paid will, in turn, cause changes to the taxpayer's 1040. Those changes on the 1040 will impact the 199A deduction, which will impact the optimum entity type for the taxpayer for that specific tax year. This complicated and circular calculation heavily relies on an accurate and defensible reasonable compensation figure.

What is Reasonable Compensation?

Since the issue first arose in 1917, determining reasonable compensation has been an ongoing dispute. What is considered reasonable compensation for a position in one state may differ in another, or from city to city or person to person. Likewise, industries vary in their compensation for employees who may have similar titles. Add to this ongoing fluctuation in markets, changes in inflation and deflation, and a multitude of other issues, and it is understandable how this issue has haunted the IRS and tax filers for more than a century.

The IRS defines reasonable compensation as, "the value that would ordinarily be paid for like services by like enterprises under like circumstances" (IRS, 2018a). This definition does not necessarily clarify how to calculate an accurate reasonable compensation figure.

Additionally, many business owners conflate how profitable an S Corp is with how much their reasonable compensation should be, often over- or under-paying themselves. Four fundamental facts help to outline how profit and reasonable compensation differ:

Reasonable compensation is based on the value of service provided, not profit or distributions.
Wages (i.e., reasonable compensation) should be paid BEFORE distributions are made.
A shareholder-employee can take wages without taking a distribution, but not vice versa.
A shareholder-employee who does not want to take any reasonable compensation can refuse ALL compensation and play "catch up" in a later year.

Profitability and distributions are fundamentally two separate and distinct elements. Reasonable compensation is tied to distributions, not profit or loss. IRS guidelines for reasonable compensation state, "the amount of reasonable compensation will never exceed the amounts received by the shareholder either directly or indirectly" (IRS, 2019). Whether the company is making or losing money is irrelevant. The sole issue is whether the owner of the S Corp is taking money out of the S Corp.

How to Derive Reasonable Compensation?

There are three basic methods employed to determine reasonable compensation for the owner of a closely-held business (S Corporation). There isn't a single right or wrong methodology. Instead, the tax professional should examine the factors for each business owner (e.g., owner's job duties, business's size).

Cost Approach
The cost approach (also known as the "many hats" approach) generally works best for small businesses wherein the owner is responsible for many different tasks. Their role can't be classified by one single title. Someone who owns and operates a small bakery, for example, is responsible for baking, ordering supplies, customer service, accounting, and cleaning, among many other roles.

The cost approach breaks down the time spent by the owner performing each task and assigns them wage levels. This approach relies heavily on comparability data. In other words, what are other workers paid with similar job duties, similar experience, and within a similar geographical area? The cost approach calculates a reasonable compensation value through four basic steps:

Step One: List all of the services the business owner provides to their company, making sure to include even those that aren't income-producing.

Step Two: Estimate the amount of time devoted to the business and subdivide that time based on an approximation of the time spent on each task listed in Step One. A key factor when defending a reasonable compensation figure is time and effort devoted to the business.

Step Three: Having listed all the services the owner provides to the business and how much time was spent on each service, gather reliable wage data to match the services listed. Wage data should match both the service provided and the proficiency level of the business owner. Comparable wage data should be drawn from the location of the business where the services are performed, as wage data can vary drastically between cities, counties, and states.

Step Four: Calculate the time spent on each service by the wage data. The total of these annual figures will be combined to find the owner's reasonable compensation figure.

The final figure is what the IRS and Courts call the business owner's "replacement cost" or "fair market value."

Market Approach
The market approach (also known as the industry comparison approach) determines reasonable compensation by answering the question: How much compensation would be paid for the same position, held by a non-owner in an arms-length relationship at a similar company?

This approach seeks to determine the owner's compensation by analyzing the compensation of employees in businesses of similar size and from the same industry, as well as in comparable locations. The market approach focuses strongly on the owner's business type and the specific position held by the owner: typically CEO or General Manager. This approach then compares both the business type and the position of the owner to that of its peers to conclude what reasonable compensation should be.

The market approach works best when the owner's time is devoted to only one occupation (usually in upper management) and can be easily compared to peers working in the same industry with similarly sized companies and comparable geographic areas. Due to these factors, the market approach is the preferred methodology when working with larger small companies and medium-sized closely held businesses where the owner is responsible solely for running the company (titles such as general manager or chief executive).

Income Approach
The income approach (also known as the independent investor test) seeks to determine whether a hypothetical investor would be satisfied with their return on investment when looking at the financial performance of the business in conjunction with the compensation level of the owner. To determine reasonable compensation using the income approach there are three key pieces of information:

- Fair market value (FMV) of the business at the beginning of the year.
- Increase in FMV by the end of the year before owner compensation.
- Target return of the independent investor.

Once these three values have been determined they are put into an Income Approach Calculator and the reasonable compensation is calculated.

Of the three methods discussed, the income approach is the only method that does not rely on comparability data but instead draws a conclusion for what reasonable compensation should be based on the financial performance of the business. This approach generally works best for outliers.

Outliers are business owners whose achievements are so great that they deserve compensation above that of their peers (sometimes referred to as a superior/key employee), or perform a unique occupation, skill or duty where no comparability data exists. In these cases, the income approach would be an appropriate choice.

Case Studies

To further demonstrate the three approaches to reasonable compensation, a case study will be employed. Scott Stone is 30 years old and a full-time graduate student studying chemistry. His father, due to health issues, is forced to retire from the family business, Stone Concrete (an S Corporation). Scott, who grew up helping his father with the business, becomes 100% owner. The company has five employees, and Scott is a full-time employee working 40+ hours per week. The company has a yearly gross revenue of $250,000.

Study One: Cost Approach

Scott meets with his CPA, and they decide to take a cost approach methodology to determine his reasonable compensation. The first thing they must do is decide the many roles Scott performs at Stone Concrete, how much of his time is dedicated to each role and his proficiency. The below table represents what Scott and his CPA determined.

Title	Time %	Proficiency
Sales Representative	10%	Below Average
Bookkeeper	10%	Below Average
Purchasing Clerk	5%	Average
Office Manager	15%	Average
Concrete Finisher	30%	Above Average
Maintenance Mechanic	30%	Above Average
	100%	TOTAL

Once Scott and his CPA have allocated his time and roles properly, the CPA will run a wage analysis based on the location of Stone Concrete (Cook County, Chicago, IL).

Title	Time %	Proficiency	Hours	Wage	Annual
Sales Representative	10%	Below Average	208	$20.49	$4,262
Bookkeeper	10%	Below Average	208	$16.21	$3,372
Purchasing Clerk	5%	Average	104	$21.76	$2,263
Office Manager	15%	Average	312	$42.13	$6,572
Concrete Finisher	30%	Above Average	624	$45.36	$28,305
Maintenance Mechanic	30%	Above Average	624	$27.84	$17,372
	100%	TOTAL	2,080		$62,146*

*rounding errors may account for different figures

Scott's reasonable compensation has been calculated at $62, 146.

Study Two: Market Approach
Stone Concrete has flourished in the last 15 years under Scott's leadership. Now 45 years old, Scott is the General Manager overseeing the company, which now has 35 employees and has approximately $7 million in gross revenue. Scott works around 55 hours per week, though he has still found time to start a new company, Stone Technologies. As a medium-sized business, Scott's CPA decides to employ the market approach to determine his reasonable compensation.

In order to gain an accurate representation of Scott's performance compared to his peers, his CPA creates a profile of Scott and Stone Concrete. It gathers relevant facts that will be used to find comparable businesses to compare to Stone Concrete and their managements pay.

Industry	Specialty trade contractors
Occupation	General Manager
State	Illinois
Metro Area	Chicago
Number of employees	35
Gross revenue	$7 million
Business Experience vs. Peers	Above average
Owner Experience vs. Peers	High
Hours worked per week	55

Scott's CPA runs this information through his reasonable compensation calculator to analyze comparable businesses. The report generated would look something like the diagram below.

	Lowest	Highest	Suggested
Chicago-Naperville-Elgin, IL-IN-WI	$134,635	$171,340	$148,630
Illinois	$126,555	$161,034	$139,690
National	$126,919	$161,498	$140,092

Following completion of his analysis, Scott's CPA recommends he use the suggested wage for a General Manager across three comparable cities (Chicago, IL – Naperville, IN – Elgin, WI) and Scott decides on $148,630 as his reasonable compensation.

Study Three: Income Approach

At age 55, Scott has transitioned away from Stone Concrete and is now the owner of Stone Technologies. He is also the inventor and patent-holder of a new chemical formulation of "seamless concrete" which will significantly increase the lifespan of concrete by eliminating cracks and seams. Scott had Stone Technologies valued, and the fair market value (FMV) was $6 million but with an expected increase of $1.7 million over the next year. For this type of company, investors would expect a return on investment (ROI) of roughly 20%.

Given the unique position Stone Technologies is in, it would be challenging to find any comparable wage data. Few companies hold a unique patent for a product that could change the state of infrastructure and building the world over. As such, the best means for determining his reasonable compensation is to employ an Income Approach Calculator, which requires the following data:

Estimated FMV beginning of the year:	6,000,000
Estimated increase in FMV by year end:	1,750,000
Target return (independent investor rate):	20%

The Income Approach Calculator will determine the expected return on equity (year-end) and his reasonable compensation using the same formula as the IRS. In the case of Scott Stone, his reasonable compensation is determined to be $550,000 for the year.

What is RCReports?

RCReports specializes in helping tax professionals engage in best-practices for providing reasonable compensation for small and medium closely-held business owners. They encourage S Corp clients to engage in reasonable compensation analysis on a yearly basis applying a systematic approach for deriving their reasonable compensation figure. Best practices include utilizing credible and independent data that meet IRS criteria and are supported by court rulings and industry standard salary intelligence.

RCReports helps tax professionals increase their productivity through a simple and intuitive web-based reasonable compensation system. This decreases the time taken for reasonable compensation analysis and provides an additional revenue stream. Most importantly, it reduces the risk to business owners by providing defensible, accurate, and objective reasonable compensation figures.

References

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Author

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Paul is the Founder and President of RCReports, Inc., a company that provides Reasonable Compensation software tools and consulting services to the accounting industry. Mr. Hamann has been the visionary behind the creation of RCReports.com, the first online application for establishing Reasonable Compensation for Closely Held Business Owners. For more than 20 years, Mr. Hamann has been consulting on the issue of compensation as an Executive Recruiter and Small Business Advisor. Mr. Hamann founded RCReports, Inc. an online application that determines Reasonable Compensation for Closely-held Business Owners. Paul has started and led several successful businesses since graduating from the University of Colorado, Boulder - School of Business with a Bachelor's degree in Small Business & Entrepreneurship in 1989.

About RCReports Reasonable Compensation Solutions

RCReports provides instant and accurate insights into Reasonable Compensation for closely held businesses to ensure your clients remain compliant, minimize risk and realize maximum payroll tax savings. With in-built industry, legal, IRS criteria and salary data intelligence, tax advisors, valuators and forensic accountants gain access to credible and independent Reasonable Compensation calculations with guaranteed cover in the event of an IRS audit or litigation. Access reports for planning, compliance or normalization within minutes through an intuitive, cloud-based platform, removing all guesswork and providing full documentation and transparency around your clients' compensation

For more information about RCReports visit rcreports.com or call 720-279-8800.

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